an INTRODUCTION *to* ISLAMIC FINANCE

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بسم ا الر ن الرحيم

ا مد رب العا ، والصلاة والسلام على رسوله الكر

وعلى آله وصحبه أ ع ، وعلى من تبعهم بإحسان

إ يوم الدين

Foreword

Over the last few decades, the Muslims have been trying to restructure their lives on the basis of Islamic principles. They strongly feel that the political and economic dominance of the West, during past centuries, has deprived them of the divine guidance, especially in the socio-economic fields. Therefore, after acquiring political freedom, the masses are striving for the revival of their Islamic identity to organise their collective life in accordance with the Islamic teachings.

In the economic field, it was the biggest challenge for such Muslims to reform their financial institutions to bring them in harmony with the dictates of Shari‘ah. In an environment where the entire financial system was based on interest, it was a formidable task to structure the financial institutions on an interest free basis.

The people not conversant with the principles of Shari‘ah and its economic philosophy sometimes believe that abolishing interest from the banks and financial institutions would make them charitable, rather than commercial, concerns which offer financial services without a return.

Obviously, this is totally a wrong assumption. According to Shari‘ah, interest free loans are meant for cooperative and charitable activities, and not normally for commercial transactions, except in a very limited range. So far as commercial financing is concerned, the Islamic Shari‘ah has a different set-up for that purpose. The

principle is that the person extending money to another person must decide whether he wishes to help the opposite party or he wants to share his profits. If he wants to help the borrower, he must rescind from any claim to any additional amount. His principal will be secured and guaranteed, but no return over and above the principal amount is legitimate. But if he is advancing money to share the profits earned by the other party, he can claim a stipulated proportion of profit actually earned by him, and must share his loss also, if he suffers a loss.

It is thus obvious that exclusion of interest from financial activities does not necessarily mean that the financier cannot earn a profit. If financing is meant for a commercial purpose, it can be based on the concept of profit and loss sharing, for which *musharakah* and *mudarabah* have been designed since the very inception of the Islamic commercial law.

There are, however, some sectors where financing on the basis of *musharakah* or *mudarabah* is not workable or feasible for one reason or another. For such sectors the contemporary scholars have suggested some other instruments which can be used for the purpose of financing, like *murabahah*, *ijarah*, *salam* or *istisna*.

Since last two decades, these modes of financing are being used by the Islamic banks and financial institutions. But all these instruments are not the substitutes of interest in the strict sense, and it will be wrong to presume that they may be used exactly in the same fashion as interest is used. They have their own set of principles, philosophy and conditions without which it is not allowed in Shari‘ah to use them as modes of financing. Therefore the ignorance of their basic concept and relevant details may lead to confusing the Islamic financing with the conventional system based on interest.

The present book is a revised collection of my different articles that aimed at providing basic information about the principles and precepts of Islamic finance, with special reference to the modes of financing used by the Islamic banks and non-banking financial institutions. I have tried to explain the basic concept underlying these instruments, the necessary requirements for their acceptability from the Shari‘ah standpoint, and the correct method of their application. I have also dealt with the practical issues involved in the

application of these instruments and their possible solutions in the light of Shari'ah.

In my capacity as chairman / member of the Shari'ah Supervisory Boards of a number of Islamic banks in different parts of the world, I came across the points of weakness in their operations caused mainly by the lack of clear perception of the relevant rules and principles of Shari'ah. This experience emphasized the need for the present book in which I have tried to discuss the relevant subject in a simple way which may be easily understood by a common reader who had no opportunities to study the Islamic financial principles in depth.

This humble effort, I hope, will facilitate to understand the basic principles of Islamic finance and the main points of difference between conventional and Islamic banking. May Allah Ta'ala accept this humble effort, honour it with His pleasure and make it beneficial for the readers.

وما توفيقي إلا با

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I

Some Preliminary Points

Before the details of Islamic modes of financing are discussed, it seems necessary to explain some points concerning the basic principles that govern the whole economic set-up in an Islamic way of life.

Belief in Divine Guidance

The foremost belief around which all the Islamic concepts revolve is that the whole universe is created and controlled by One, the only One God. He has created man and appointed him as His vicegerent on the earth to fulfil certain objectives through obeying His commands. These commands are not restricted to some modes of worship or so-called religious rituals. They, on the contrary, cover a substantial area of almost every aspect of our life. These commands are neither so exhaustive that straiten the human activities within a narrow circle, leaving no role for human intellect to play, nor are they so little or ambiguous that they leave every sphere of life at the mercy of human perception and desire. Far from these two extremes, Islam has a balanced approach to govern the human life. On the one hand, it has left a very wide area of human activities to man's own rational judgment where he can take decisions on the basis of his reason, assessment of facts and expedience. On the other hand, Islam has subjected human activities to a set of principles which have eternal application and cannot be violated on superficial grounds of expediency based on human assessment.

The fact behind this scheme is that human reason, despite its vast capabilities, cannot claim to have unlimited power to reach the truth. After all, it has some limits beyond which it either cannot properly work or may fall prey to errors. There are numerous domains of human life where 'reason' is often confused with 'desires' and where unhealthy instincts, under the disguise of rational arguments, misguide humanity to wrong and destructive decisions. All those theories of the past which are held today to be fallacious, claimed, in their respective times, to be 'rational' but it was after centuries that their fallacy was discovered and their absurdity was universally proved.

It is thus evident that the sphere of work delegated to human 'reason' by its Creator is not unlimited. There are areas in which human reason cannot give proper guidance or, at least, is susceptible to errors. It is these areas in which Allah Almighty, the Creator of the universe, has provided guidance through His revelations sent down to His prophets. On the basis of this approach it is the firm belief of every Muslim that the commands given by the divine revelations through the last Messenger ﷺ are to be followed in letter and spirit and cannot be violated or ignored on the basis of one's rational arguments or his inner desires. Therefore, all the human activities must always be subject to these commands and must work within the limits prescribed by them. Unlike other religions, Islam is not confined to some moral teachings, some rituals or some modes of worship. It rather contains guidance in every sphere of life including socio-economic fields. The obedience from servants of Allah is required not only in worship, but also in their economic activities, even though it is at the price of some apparent benefits, because these apparent benefits may go against the collective interest of the society.

The Basic Difference between Capitalist and Islamic Economy

Islam does not deny the market forces and market economy. Even the profit motive is acceptable to a reasonable extent. Private ownership is not totally negated. Yet, the basic difference between capitalist and Islamic economy is that in secular capitalism, the profit motive or private ownership are given unbridled power to

make economic decisions. Their liberty is not controlled by any divine injunctions. If there are some restrictions, they are imposed by human beings and are always subject to change through democratic legislation, which accepts no authority of any super-human power. This attitude has allowed a number of practices which cause imbalances in the society. Interest, gambling, speculative transactions tend to concentrate wealth in the hands of the few. Unhealthy human instincts are exploited to make money through immoral and injurious products. Unbridled profit making creates monopolies which paralyse the market forces or, at least, hinder their natural operation. Thus the capitalist economy which claims to be based on market forces, practically stops the natural process of supply and demand, because these forces can properly work only in an atmosphere of free competition, and not in monopolies. It is sometimes appreciated in a secular capitalist economy that a certain economic activity is not in the interest of the society, yet, it is allowed to be continued because it goes against the interest of some influential circles who dominate the legislature on the strength of their majority. Since every authority beyond the democratic rule is totally denied and 'trust in God' (which is affirmed at the face of every U.S. dollar) has been practically expelled from the socio-economic domain, no divine guidance is recognized to control the economic activities.

The evils emanating from this attitude can never be curbed unless humanity submits to the divine authority and obeys its commands by accepting them as absolute truth and super-human injunctions which should be followed in any case and at any price. This is exactly what Islam does. After recognizing private ownership, profit motive and market forces, Islam has put certain divine restrictions on the economic activities. These restrictions being imposed by Allah Almighty, Whose knowledge has no limits, cannot be removed by any human authority. The prohibition of *riba* (usury or interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions are some examples of these divine restrictions. All these prohibitions combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunities.

Asset-backed Financing

One of the most important characteristics of Islamic financing is that it is an asset-backed financing. The conventional / capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; Each unit of money is 100% equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units inter se. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on illiquid assets which creates real assets and inventories.

The real and ideal instruments of financing in Shari'ah are *musharakah* and *mudarabah*. When a financier contributes money on the basis of these two instruments it is bound to be converted into the assets having intrinsic utility. Profits are generated through the sale of these real assets.

Financing on the basis of *salam* and *istisna'* also creates real assets. The financier in the case of salam receives real goods and can make profit by selling them in the market. In the case of istisna, financing is effected through manufacturing some real assets, as a reward of which the financier earns profit.

Financial leases and *murabahah*, as will be seen later in the relevant chapters, are not originally modes of financing. But, in order to meet some needs they have been reshaped in a manner that they can be used as modes of financing, subject to certain conditions, in those sectors where musharakah, mudarabah, salam or istisna' are not workable for some reasons. The instruments of leasing and murabahah are sometimes criticized on the ground that their net result is often the same as the net result of an interest-based borrowing. This criticism is justified to some extent, and that is why the Shari'ah supervisory Boards are unanimous on the point

that they are not ideal modes of financing and they should be used only in cases of need with full observation of the conditions prescribed by Shari'ah. Despite all this, the instruments of leasing and murabahah, too, are fully backed by assets and financing through these instruments is clearly distinguishable from the interest-based financing on the following grounds.

1. In conventional financing, the financier gives money to his client as an interest-bearing loan, after which he has no concern as to how the money is used by the client. In the case of murabahah, on the contrary, no money is advanced by the financier. Instead, the financier himself purchases the commodity required by the client. Since this transaction cannot be completed unless the client assures the financier that he wishes to purchase a commodity, therefore, murabahah is not possible at all, unless the financier creates inventory. In this manner, financing is always backed by assets.

2. In the conventional financing system, loans may be advanced for any profitable purpose. A gambling casino can borrow money from a bank to develop its gambling business. A pornographic magazine or a company making nude films are as good customers of a conventional bank as a house-builder. Thus, conventional financing is not bound by any divine or religious restrictions. But the Islamic banks and financial institutions cannot remain indifferent about the nature of the activity for which the facility is required. They cannot effect murabahah for any purpose which is either prohibited in Shari'ah or is harmful to the moral health of the society.

3. It is one of the basic requirements for the validity of murabahah that the commodity is purchased by the financier which means that he assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he assumes. No such risk is assumed in an interest-based loan.

4. In an interest bearing loan, the amount to be repaid by the borrower keeps on increasing with the passage of time. In murabahah, on the other hand, a selling price once agreed becomes and remains fixed. As a result, even if the purchaser (client of the Bank) does not pay on time, the seller (Bank) cannot ask for a higher price, due to delay in settlement of dues. This is because in Shari'ah, there is no concept of time due of money.

5. In leasing too, financing is offered through providing an asset having usufruct. The risk of the leased property is assumed by the lessor / financier throughout the lease period in the sense that if the leased asset is totally destroyed without any misuse or negligence on the part of the lessee, it is the financier/lessor who will suffer the loss.

It is evident from the above discussion that every financing in an Islamic system creates real assets. This is true even in the case of murabahah and leasing, despite the fact that they are not believed to be ideal modes of financing and are often criticized for their being close to the interest-based financing in their net results. It is known, on the other hand, that interest-based financing does not necessarily create real assets, therefore, the supply of money through the loans advanced by the financial institutions does not normally match with the real goods and services produced in the society, because the loans create artificial money through which the amount of money supply is increased, and sometimes multiplied without creating real assets in the same quantity. This gap between the supply of money and production of real assets creates or fuels inflation. Since financing in an Islamic system is backed by assets, it is always matched with corresponding goods and services.

Capital and Entrepreneur

According to the capitalist theory, capital and entrepreneur are two separate factors of production. The former gets interest while the latter is entitled to profit. Interest is a fixed return for providing capital, while profit can be earned only when there is a surplus after distributing the fixed return to land, labour and capital (in the form of rent, wages and interest).

Islam, on the contrary, does not recognize capital and entrepreneur as two separate factors of production. Every person who contributes capital (in the form of money) to a commercial enterprise assumes the risk of loss and therefore is entitled to a proportionate share in the actual profit. In this manner 'capital' has an intrinsic element of 'entrepreneurship', so far as the risk of the business is concerned. Therefore, instead of a fixed return as interest, it derives profit. The more the profit of the business, the higher the return on capital. In this way the profits generated by the

commercial activities in the society are equitably distributed to all those persons who have contributed capital to the enterprise, however little it may be. Since in the context of the modern practice, it is the banks and financial institutions who provide capital to the commercial activities, out of the deposits made with them, the flow of the actual profits earned by the society may be directed towards the depositors in equitable proportions which may distribute wealth in a wider circle and may hamper concentration of wealth in the hands of the few.

Present Practices of Islamic Banks

It is sometimes argued against the Islamic financial system that the Islamic banks and financial institutions, working since last three decades, did not bring any visible change in the economic set-up, not even in the field of financing. This indicates that the boastful claims of creating 'distributive justice' under the umbrella of Islamic banking are exaggerated.

This criticism is not realistic, because it does not take into account the fact that, in proportion to the conventional banking, the Islamic banks and financial institutions are no more than a small drop in an ocean, and therefore, they cannot be supposed to revolutionise the economy in a short period.

Secondly, these institutions are passing through their age of infancy. They have to work under a large number of constraints, therefore, some of them have not been able to comply with all the requirements of Shari'ah in all their transactions, therefore, each and every transaction carried out by them cannot be attributed to Shari'ah.

Thirdly, the Islamic banks and financial institutions are not normally supported by the governments, legal and taxation system and the central banks of their respective countries. Under these circumstances, they have been given certain concessions, on the grounds of need or necessity, which are not based on the original and ideal principles of Shari'ah.

Islam, being a practical way of life, has two sets of rules; one is based on the ideal objectives of Shari'ah which is applicable in normal conditions, and the second is based on some relaxations given in abnormal situations. The real Islamic order is based on the

former set of principles, while the latter is a concession which can be availed at times of need, but it does not reflect the true picture of the real Islamic order.

Living under constraints, the Islamic banks are mostly relying on the second set of rules, therefore, their activities could not bring a visible change even in the limited circle of their operations. However, if the whole financing system is based on the ideal Islamic principles, it will certainly bring a discernible impact on the economy.

It is to be noted that the present book, being a guide book to the present day financial institutions, has dealt with both types of the Islamic rules. At the outset, the ideal Islamic principles of finance have been elaborated and later on we have discussed the best possible concessions that may be availed of in the transitory period where the Islamic institutions are working under pressure of the existing legal and fiscal system. Shari'ah has specific principles about such concessions as well, and their basic purpose is to avoid clear prohibitions by adopting a less preferable line of action. This may not serve the basic purpose of establishing a true Islamic order, yet it may help one refrain from a glaring sin and save him from the evil fate of disobedience, which, in itself, is a cherished goal of a Muslim, though at individual level. Moreover, this may help the society to advance gradually to the ideal target of establishing a total Islamic order. This book should be studied in the light of this scheme of Islamic Shari'ah.

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Musharakah

'*Musharakah'* is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. In the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of every type. Since Islam has prohibited interest, this instrument cannot be used for providing funds of any kind. Therefore, musharakah can play a vital role in an economy based on Islamic principles.

'Interest' predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor, while musharakah does not envisage a fixed rate of return. Rather, the return in musharakah is based on the actual profit earned by the joint venture. The financier in an interest-bearing loan cannot suffer loss while the financier in musharakah can suffer loss, if the joint venture fails to produce fruits. Islam has termed interest as an unjust instrument of financing because it results in injustice either to the creditor or to the debtor. If the debtor suffers a loss, it is unjust on the part of the creditor to claim a fixed rate of return; and if the debtor earns a very high rate of profit, it is injustice to the creditor to give him only a small proportion of the profit leaving the rest for the debtor.

In the modern economic system, it is the banks which advance depositors' money as loans to industrialists and traders. If industrialists having only ten million of their own, acquire 90 million from the banks and embark on a huge profitable project, it

means that 90% of the project has been created by the money of the depositors while only 10% has been created by their own capital. If this huge project brings enormous profits, only a small proportion i.e. 14 or 15% will go to the depositors through the bank, while all the rest will be gained by the industrialists whose real contribution to the project is not more than 10%. Even this small proportion of 14 or 15% is taken back by the industrialists, because this proportion is included by them in the cost of their production. The net result is that all the profit of the enterprise is earned by the persons whose own capital does not exceed 10% of the total investment, while the people owning 90% of the investment get no more than the fixed rate of interest which is often repaid by them through the increased prices of the products. On the contrary, if in an extreme situation, the industrialists go insolvent, their own loss is no more than 10%, while the rest of 90% is totally borne by the bank, and in some cases, by the depositors. In this way, the rate of interest is the main cause for imbalances in the system of distribution, which has a constant tendency in favor of the rich and against the interests of the poor.

Conversely, Islam has a clear cut principle for the financier. According to Islamic principles, a financier must determine whether he is advancing a loan to assist the debtor on humanitarian grounds or he desires to share his profits. If he wants to assist the debtor, he should resist from claiming any excess on the principal of his loan, because his aim is to assist him. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share him in his losses. Thus the returns of the financier in musharakah have been tied up with the actual profits accrued through the enterprise. The greater the profits of the enterprise, the higher the rate of return to the financier. If the enterprise earns enormous profits, all of it cannot be secured by the industrialist exclusively, but they will be shared by the common people as depositors in the bank. In this way, musharakah has a tendency to favor the common people rather than the rich only.

This is the basic philosophy which explains why Islam has suggested musharakah as an alternative to the interest based financing. No doubt, musharakah embodies a number of practical problems in its full implementation as a universal mode of financing. It is sometimes presumed that musharakah is an old

instrument which cannot keep pace with the ever-advancing need for speedy transactions. However, this presumption is due to the lack of proper knowledge concerning the principles of musharakah. In fact, Islam has not prescribed a specific form or procedure for musharakah. Rather, it has set some broad principles which can accommodate numerous forms and procedures. A new form or procedure in musharakah cannot be rejected merely because it has no precedent in the past. In fact, every new form can be acceptable to the Shari'ah in so far as it does not violate any basic principle laid down by the Holy Qur'an, the Sunnah or the consensus of the Muslim jurists. Therefore, it is not necessary that musharakah be implemented only in its traditional old form.

The present chapter contains a discussion of the basic principles of musharakah and the way in which it can be implemented in the context of modern business and trade. This discussion is aimed at introducing musharakah as a modern mode of financing without violating its basic principles in any way. Musharakah has been introduced with reference to the books of Islamic jurisprudence, and basic problems which may be faced in implementing it in a modern situation. It is hoped that this brief discussion will open new horizons for the thinking of Muslim jurists and economists and may help implementing a true Islamic economy.

The Concept of Musharakah

'Musharakah' is a term frequently referred to in the context of Islamic modes of financing. The connotation of this term is a little limited than the term "*shirkah*" more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other.

"Shirkah" means "sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

(1) ***Shirkat-ul-Milk***: It means joint ownership of two or more persons in a particular property. This kind of "shirkah" may come into existence in two different ways: Sometimes it comes into operation at the option of the parties. For example, if two or more persons purchase an equipment, it will be owned jointly by both of them and the relationship between them with regard to that

property is called "shirkat-ul-milk." Here this relationship has come into existence at their own option, as they themselves elected to purchase the equipment jointly.

But there are cases where this kind of "shirkah" comes to operate automatically without any action taken by the parties. For example, after the death of a person, all his heirs inherit his property which comes into their joint ownership as an automatic consequence of the death of that person.

(2) ***Shirkat-ul-'Aqd:*** This is the second type of Shirkah which means "a partnership effected by a mutual contract". For the purpose of brevity it may also be translated as "joint commercial enterprise."

Shirkat-ul-'aqd is further divided into three kinds:

(i) *Shirkat-ul-Amwal* where all the partners invest some capital into a commercial enterprise.

(ii) *Shirkat-ul-A'mal* where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two persons agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a shirkat-ul-a'mal which is also called Shirkat-ut-taqabbul or Shirkat-us-sana'i' or Shirkat-ul-abdan.

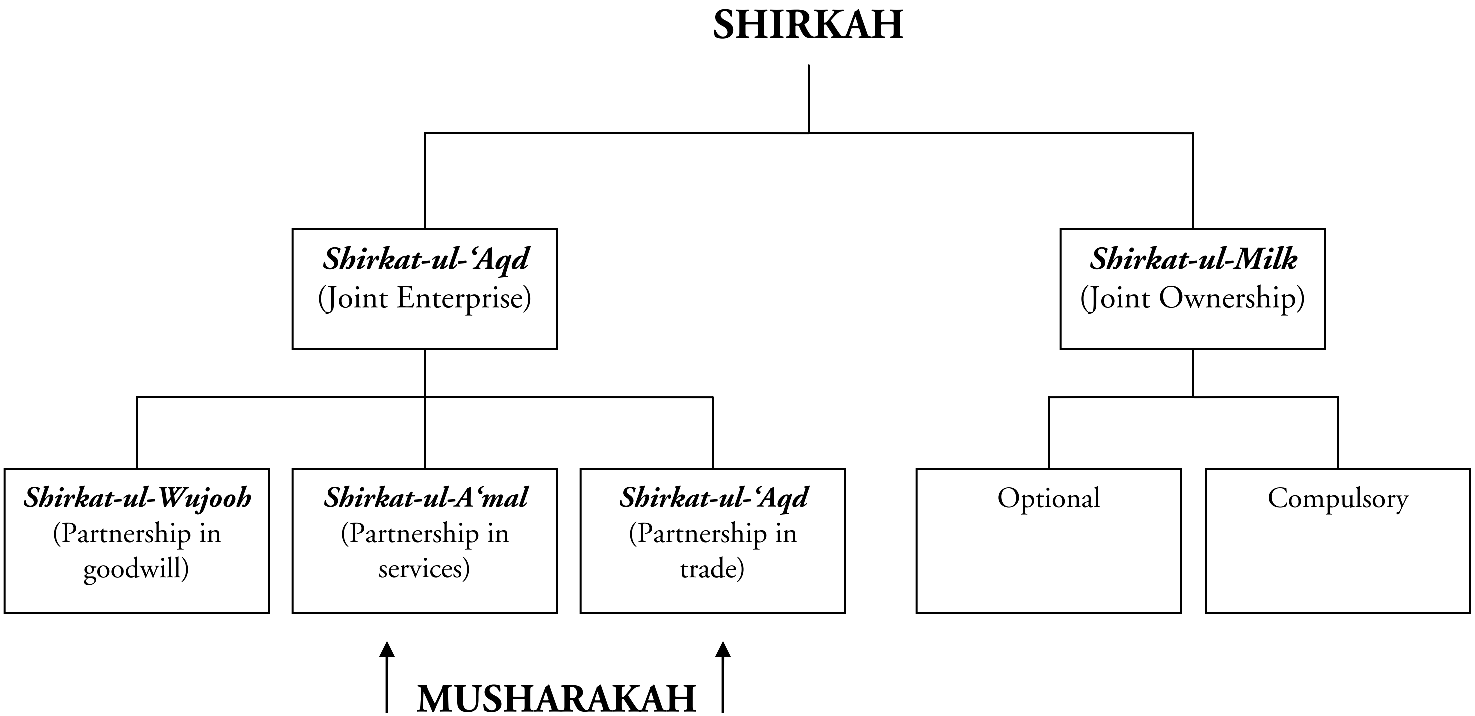
(iii) The third kind of Shirkat-ul-'aqd is Shirkat-ul-wujooh. Here the partners have no investment at all. All they do is that they purchase the commodities on a deferred price and sell them at spot. The profit so earned is distributed between them at an agreed ratio.

All these modes of "Sharing" or partnership are termed as "shirkah" in the terminology of Islamic Fiqh, while the term "musharakah" is not found in the books of Fiqh. This term (i.e. musharakah) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "Shirkah", that is, the Shirkat-ul-amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-a'mal also where partnership takes place in the business of services.

It is evident from this discussion that the term “Shirkah” has a much wider sense than the term “musharakah” as is being used today. The latter is limited to the “Shirkat-ul-amwal” only, while the former includes all types of joint ownership and those of partnership. Table 1 will show the different kinds of “Shirkah” and the two kinds which are called “musharakah” in the modern terminology.

Since “musharakah” is more relevant for the purpose of our discussion, and it is almost analogous to “Shirkat-ul-amwal”, we shall now dwell upon it, explaining at the first instance, the traditional concept of this type of Shirkah, then giving a brief account of its application to the concept of financing in the modern context.

Table 1


SHIRKAH
Shirkat-ul-'Aqd (Joint Enterprise)
Shirkat-ul-Milk (Joint Ownership)
Shirkat-ul-Wujooh (Partnership in goodwill)
Shirkat-ul-A'mal (Partnership in services)
Shirkat-ul-'Aqd (Partnership in trade)
Optional
Compulsory
MUSHARAKAH

The Basic Rules of Musharakah

1. Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc., etc.

But there are certain ingredients which are peculiar to the contract of "musharakah". They are summarized here:

Distribution of Profit

2. The proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract. If no such proportion has been determined, the contract is not valid in Shari'ah.

3. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him. It is not allowed to fix a lump sum amount for any one of the partners, or any rate of profit tied up with his investment.

Therefore, if A and B enter into a partnership and it is agreed between them that A shall be given Rs 10,000/- per month as his share in the profit, and the rest will go to B, the partnership is invalid. Similarly, if it is agreed between them that A will get 15% of his investment, the contract is not valid. The correct basis for distribution would be an agreed percentage of the actual profit accrued to the business.

If a lump sum amount or a certain percentage of the investment has been agreed for any one of the partners, it must be expressly mentioned in the agreement that it will be subject to the final settlement at the end of the term, meaning thereby that any amount so drawn by any partner shall be treated as 'on account payment' and will be adjusted to the actual profit he may deserve at the end of the term. But if no profit is actually earned or is less than anticipated, the amount drawn by the partner shall have to be returned.

Ratio of Profit

4. Is it necessary that the ratio of profit of each partner conforms to the ratio of capital invested by him? There is a difference of opinion among the Muslim jurists about this question.

In the view of Imam Malik and Imam Shafi'i, it is necessary for the validity of musharakah that each partner gets the profit exactly in the proportion of his investment. Therefore, if A has invested 40% of the total capital, he must get 40% of the profit. Any agreement to the contrary which makes him entitled to get more or less than 40% will render the musharakah invalid in Shari'ah.

On the contrary, the view of Imam Ahmad is that the ratio of profit may differ from the ratio of investment if it is agreed between the partners with their free consent. Therefore, it is permissible that a partner with 40% of investment gets 60% or 70% of the profit, while the other partner with 60% of investment gets only 40% or 30%.[1]

The third view is presented by Imam Abu Hanifah which can be taken as a via media between the two opinions mentioned above. He says that the ratio of profit may differ from the ratio of investment in normal conditions. However, if a partner has put an express condition in the agreement that he will never work for the musharakah and will remain a sleeping partner throughout the term of musharakah, then his share of profit cannot be more than the ratio of his investment.[2]

Sharing of Loss

But in the case of loss, all the Muslim jurists are unanimous on the point that each partner shall suffer the loss exactly according to the ratio of his investment. Therefore, if a partner has invested 40% of the capital, he must suffer 40% of the loss, not more, not less, and any condition to the contrary shall render the contract invalid. There is a complete consensus of jurists on this principle.[3]

Therefore, according to Imam Shafi'i, the ratio of the share of a partner in profit and loss both must conform to the ratio of his

[1] Ibn Qudamah, *Al-Mughni*, (Beirut: Dar al-Kitab al-Arabi, 1972), 5:140.
[2] Al-Kasani, *Bada'i' al-Sana'i'*, 6:162–63.
[3] Ibn Qudamah, *Al-Mughni*, 5:147.

investment. But according to Imam Abu Hanifah and Imam Ahmad, the ratio of the profit may differ from the ratio of investment according to the agreement of the partners, but the loss must be divided between them exactly in accordance with the ratio of capital invested by each one of them. It is this principle that has been mentioned in the famous maxim:

الربح على ما اصطلحا عليه والوضيعة على قدر ا ال

> Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.

The Nature of the Capital

Most of the Muslim jurists are of the opinion that the capital invested by each partner must be in liquid form. It means that the contract of musharakah can be based only on money, and not on commodities. In other words, the share capital of a joint venture must be in monetary form. No part of it can be contributed in kind. However, there are different views in this respect.

1. Imam Malik is of the view that the liquidity of capital is not a condition for the validity of musharakah, therefore, it is permissible that a partner contributes to the musharakah in kind, but his share shall be determined on the basis of evaluation according to the market price prevalent at the date of the contract. This view is also adopted by some Hanbali jurists.[4]

2. Imam Abu Hanifah and Imam Ahmad are of the view that no contribution in kind is acceptable in a musharakah. Their standpoint is based on two reasons:

Firstly, they say that the commodities of each partner are always distinguishable from the commodities of the other. For example, if A has contributed one motor car to the business, and B has come with another motor car, each one of the two cars is the exclusive property of its original owner. Now, if the car of A is sold, its sale-proceeds should go to A. B has no right to claim a share in its price. Therefore, so far as the property of each partner is distinguished from the property of the other, no partnership can take place. On the contrary, if the capital invested by every partner is in the form of

[4] Ibn Qudamah, *Al-Mughni*, 5:125.

money, the share capital of each partner cannot be distinguished from that of the other, because the units of money are not distinguishable, therefore, they will be deemed to form a common pool, and thus the partnership comes into existence.[5]

Secondly, they say, there are a number of situations in a contract of musharakah where the partners have to resort to redistribution of the share-capital to each partner. If the share-capital was in the form of commodities, such redistribution cannot take place, because the commodities may have been sold at that time. If the capital is repaid on the basis of its value, the value may have increased, and there is a possibility that a partner gets all the profit of the business, because of the appreciation in the value of the commodities he has invested, leaving nothing for the other partner. Conversely, if the value of those commodities decreases, there is a possibility that one partner secures some part of the original price of the commodity of the other partner in addition to his own investment.[6]

3. Imam al-Shafi'i has come with a via media between the two points of view explained above. He says that the commodities are of two kinds:

(i) ***Dhawat-ul-amthal*** **(ذوات الأمثال)** i.e. the commodities which, if destroyed, can be compensated by the similar commodities in quality and quantity e.g. wheat, rice etc. If 100 kilograms of wheat are destroyed, they can easily be replaced by another 100 kg. of wheat of the same quality.

(ii) ***Dhawat-ul-qeemah*** **(ذوات القيمة)** i.e. the commodities which cannot be compensated by the similar commodities, like the cattle. Each head of sheep, for example, has its own characteristics which cannot be found in any other head. Therefore, if somebody kills the sheep of a person, he cannot compensate him by giving him similar sheep. Rather, he is required to pay their price.

Now, Imam al-Shafi'i says that the commodities of the first kind (i.e. dhawat-ul-amthal) may be contributed to the musharakah as the share of a partner in the capital, while the commodities of the

[5] Al-Kasani, *Bada'i' al-Sana'i'*, 6:59.
[6] Ibn Qudamah, *Al-Mughni*, 5:124–25.

second kind (i.e. the dhawat-ul-qeemah) cannot form part of the share capital.[7]

By this distinction between dhawat-ul-amthal and dhawat-ul-qeemah, Imam al-Shafi'i has met the second objection on 'participation by commodities' as was raised by Imam Ahmad. For in the case of dhawat-ul-amthal, redistribution of capital may take place by giving to each partner the similar commodities he had invested. However, the first objection remains still unanswered by Imam al-Shafi'i.

In order to meet this objection also, Imam Abu Hanifah says that the commodities falling under the category of dhawat-ul-amthal can form part of the share capital only if the commodities contributed by each partner have been mixed together, in such a way that the commodity of one partner cannot be distinguished from that of the other.[8]

In short, if a partner wants to participate in a musharakah by contributing some commodities to it, he can do so according to Imam Malik without any restriction, and his share in the musharakah shall be determined on the basis of the current market value of the commodities, prevalent at the date of the commencement of musharakah. According to Imam al-Shafi'i, however, this can be done only if the commodity is from the category of dhawat-ul-amthal.

According to Imam Abu Hanifah, if the commodities are dhawat-ul-amthal, this can be done by mixing the commodities of each partner together. And if the commodities are dhawat-ul-qeemah, then, they cannot form part of the share capital.

It seems that the view of Imam Malik is more simple and reasonable and meets the needs of the modern business. Therefore, this view can be acted upon.[9]

We may, therefore, conclude from the above discussion that the share capital in a musharakah can be contributed either in cash or in the form of commodities. In the latter case, the market value of the commodities shall determine the share of the partner in the capital.

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[7] Ibid., 125.

[8] Al-Kasani, op cit.

[9] Ashraf Ali Thanawi, *Imdad al-Fatawa*.

Management of Musharakah

The normal principle of musharakah is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the musharakah. But in this case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment, as discussed earlier.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all the matters of the business and any work done by one of them in the normal course of business shall be deemed to be authorized by all the partners.

Termination of Musharakah

Musharakah is deemed to be terminated in any one of the following events:

(1) Every partner has a right to terminate the musharakah at any time after giving his partner a notice to this effect, whereby the musharakah will come to an end.

In this case, if the assets of the musharakah are in cash form, all of them will be distributed pro rata between the partners. But if the assets are not liquidated, the partners may agree either on the liquidation of the assets, or on their distribution or partition between the partners as they are. If there is a dispute between the partners in this matter i.e. one partner seeks liquidation while the other wants partition or distribution of the non-liquid assets themselves, the latter shall be preferred, because after the termination of musharakah, all the assets are in the joint ownership of the partners, and a co-owner has a right to seek partition or separation, and no one can compel him on liquidation. However, if the assets are such that they cannot be separated or partitioned, such as machinery, then they shall be sold and the sale-proceeds shall be distributed.[10]

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[10] Ibn Qudamah, *Al-Mughni*, 5:133–34.

(2) If any one of the partners dies during the currency of musharakah, the contract of musharakah with him stands terminated. His heirs in this case, will have the option either to draw the share of the deceased from the business, or to continue with the contract of musharakah.[11]

(3) If any one of the partners becomes insane or otherwise becomes incapable of effecting commercial transactions, the musharakah stands terminated.[12]

Termination of Musharakah without Closing the Business

If one of the partners wants termination of the musharakah, while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of musharakah with one partner does not imply its termination between the other partners.[13]

However, in this case, the price of the share of the leaving partner must be determined by mutual consent, and if there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.

The question arises whether the partners can agree, while entering into the contract of the musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners, or the majority of them wants to do so, and that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation.

Most of the traditional books of Islamic Fiqh seem to be silent on this question. However, it appears that there is no bar from the Shari'ah point of view if the partners agree to such a condition right

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[11] Ibid.

[12] Op cit.

[13] See *al-Fatawa al-Hindiyyah*, 2:335–36.

at the beginning of the musharakah. This is expressly permitted by some Hanbali jurists.[14]

This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success, and the liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long term project, and one of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or separation. Therefore, such a condition seems to be justified, and it can be supported by the general principle laid down by the Holy Prophet ﷺ in his famous hadith:

ا سلمون على شروطهم الا شرطا احل حراما او حرم حلالا

> All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

So far the basic concept of shirkat-ul-amwal or musharakah in its original and traditional sense have been summarized.

Now we are in a position to discuss some basic issues involved in its application to the modern conditions as an approved mode of financing. But it seems more pertinent to discuss these issues after giving an introductory account of mudarabah which is another type of profit-sharing and a typical mode of financing. Since the rules of financing in both musharakah and mudarabah are similar and the issues involved in their application are inter related, it will be more useful to discuss the concept of mudarabah before embarking on these issues.

[14] See al-Mardawi, *al-Insaf* (Beirut, 1400 AH), 5:423.

3

Mudarabah

"*Mudarabah*" is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "*rabb-ul-mal*", while the management and work is an exclusive responsibility of the other, who is called "*mudarib*".

The difference between musharakah and mudarabah can be summarized in the following points:

(1) The investment in musharakah comes from all the partners, while in mudarabah, investment is the sole responsibility of rabb-ul-mal.

(2) In musharakah, all the partners can participate in the management of the business and can work for it, while in mudarabah, the rabb-ul-mal has no right to participate in the management which is carried out by the mudarib only.

(3) In musharakah all the partners share the loss to the extent of the ratio of their investment while in mudarabah the loss, if any, is suffered by the rabb-ul-mal only, because the mudarib does not invest anything. His loss is restricted to the fact that his labor has gone in vain and his work has not brought any fruit to him. However, this principle is subject to a condition that the mudarib has worked with due diligence which is normally required for the business of that type. If he has worked with negligence or has committed dishonesty, he shall be liable for the loss caused by his negligence or misconduct.

(4) The liability of the partners in musharakah is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in liquidation, all the exceeding

liabilities shall be borne pro rata by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. Contrary to this is the case of mudarabah. Here the liability of rabb-ul-mal is limited to his investment, unless he has permitted the mudarib to incur debts on his behalf.

(5) In musharakah, as soon as the partners mix up their capital in a joint pool, all the assets of the musharakah become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can benefit from the appreciation in the value of the assets, even if profit has not accrued through sales.

The case of mudarabah is different. Here all the goods purchased by the mudarib are solely owned by the rabb-ul-mal, and the mudarib can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased.[1]

Business of the Mudarabah

The rabb-ul-mal may specify a particular business for the mudarib, in which case he shall invest the money in that particular business only. This is called al-mudarabah al-muqayyadah (restricted mudarabah). But if he has left it open for the mudarib to undertake whatever business he wishes, the mudarib shall be authorized to invest the money in any business he deems fit. This type of mudarabah is called "*al-mudarabah al-mutlaqah*" (unrestricted mudarabah)

A rabbul-mal can contract mudarabah with more than one person through a single transaction. It means that he can offer his money to A and B both, so that each one of them can act for him as

[1] However, some jurists have opined that any natural increase in the capital may be taken as a profit distributable between the rabbul-mal and mudarib. For example, if the capital was in the form of sheep, and lambs were born to some of them, these lambs will be taken as profit and will be shared between the parties according to the agreed proportions (see al-Nawawi, *Rawdat al-Talibin*, 5:125). But this is a minority view.

mudarib and the capital of the mudarabah shall be utilized by both of them jointly, and the share of the mudarib shall be distributed between them according to the agreed proportion.[2] In this case both the mudaribs shall run the business as if they were partners inter se.

The mudarib or mudaribs, as the case may be, are authorized to do anything which is normally done in the course of business. However, if they want to do an extraordinary work, which is beyond the normal routine of the traders, they cannot do so without express permission from the rabb-ul-mal.

Distribution of the Profit

It is necessary for the validity of mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. No particular proportion has been prescribed by the Shari'ah; rather, it has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the rabb-ul-mal and the mudarib. However, they cannot allocate a lump sum amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs. 100000/- they cannot agree on a condition that Rs. 10000/- out of the profit shall be the share of the mudarib, nor can they say that 20% of the capital shall be given to rabb-ul-mal. However, they can agree on that 40% of the actual profit shall go to the mudarib and 60% to the rabb-ul-mal or vice versa.

It is also allowed that different proportions are agreed in different situations. For example the rabbul-mal can say to mudarib, "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit, and if you do it in another town, your share will be 50% of the profit." [3]

Apart from the agreed proportion of the profit, as determined in the above manner, the mudarib cannot claim any periodical salary

[2] Ibn Qudamah, *Al-Mughni*, 5:145.
[3] Al-Kasani, *Bada'i' al-Sana'i'*, 6:99.

or a fee or remuneration for the work done by him for the mudarabah.[4]

All the schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the mudarib to draw his daily expenses of food only from the mudarabah account.[5]

The Hanafi jurists restrict this right of the mudarib only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc., but he is not entitled to get anything as daily allowances when he is in his own city.[6]

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.[7]

Termination of Mudarabah

The contract of mudarabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the mudarabah are not in the cash form, the mudarib shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined.[8]

There is a difference of opinion among the Muslim jurists about the question whether the contract of mudarabah can be effected for a specified period after which it terminates automatically. The Hanafi and Hanbali schools are of the view that the mudarabah can be restricted to a particular term, like one year, six months, etc, after which it will come to an end without a notice. On the contrary,

[4] Al-Sarakhsi, *al-Mabsut*, 22:149–50.
[5] Ibn Qudamah, *Al-Mughni*, 5:186.
[6] Al-Kasani, *Bada'i' al-Sana'i'*, 6:109.
[7] Ibn Qudamah, *Al-Mughni*, 5:168.
[8] Al-Kasani, *Bada'i' al-Sana'i'*, 6:109.

Shafi'i and Maliki schools are of the opinion that the mudarabah cannot be restricted to a particular time.[9]

However, this difference of opinion relates only to the maximum time-limit of the mudarabah. Can a minimum time-limit also be fixed by the parties before which mudarabah cannot be terminated? No express answer to this question is found in the books of Islamic Fiqh, but it appears from the general principles enumerated therein that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he wishes.

This unlimited power of the parties to terminate the mudarabah at their pleasure may create some difficulties in the context of the present circumstances, because most of the commercial enterprises today need time to bring fruits. They also demand constant and complex efforts. Therefore, it may be disastrous to the project, if the rabb-ul-mal terminates the mudarabah right in the beginning of the enterprise. Specially, it may bring a severe set-back to the mudarib who will earn nothing despite all his efforts. Therefore, if the parties agree, when entering into the mudarabah, that no party shall terminate it during a specified period, except in specified circumstances, it does not seem to violate any principle of Shari'ah, particularly in the light of the famous hadith, already quoted, which says:

ا سلمون على شروطهم الا شرطا احل حراما او حرم حلالا

> All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

Combination of Musharakah and Mudarabah

A contract of mudarabah normally presumes that the mudarib has not invested anything to the mudarabah. He is responsible for the management only, while all the investment comes from rabb-ul-mal. But there may be situations where mudarib also wants to invest some of his money into the business of mudarabah. In such cases, musharakah and mudarabah are combined together. For example, A

[9] Ibid., 6:99. See also Ibn Qudamah, *al-Mughni*, 5:185–86 and al-Sarakhsi, *al-Mabsut*, 22:133.

gave to B Rs. 100000/- in a contract of mudarabah. B added Rs. 50000/- from his own pocket with the permission of A. This type of partnership will be treated as a combination of musharakah and mudarabah. Here the mudarib may allocate for himself a certain percentage of profit on account of his investment as a sharik, and at the same time he may allocate another percentage for his management and work as a mudarib. The normal basis for allocation of the profit in the above example would be that B shall secure one third of the actual profit on account of his investment, and the remaining two thirds of the profit shall be distributed between them equally. However, the parties may agree on any other proportion. The only condition is that the sleeping partner should not get more percentage than the proportion of his investment.

Therefore, in the aforesaid example, A cannot allocate for himself more than two thirds of the total profit, because he has not invested more than two thirds of the total capital. Short of that, they can agree on any proportion. If they have agreed on that the total profit will be distributed equally, it means that one third of the profit shall go to B as an investor, while one fourth of the remaining two thirds will go to him as a mudarib. The rest will be given to A as "rabb-ul-mal."[10]

[10] See Ibn Qudamah, *al-Mughni*, 5:136–37; and al-Kasani, *Bada'i' al-Sana'i'*.

4

Musharakah & Mudarabah as Modes of Financing

In the foregoing sections, the traditional concept of musharakah and mudarabah and the basic principles of Shari'ah governing them have been explained. It is pertinent now to discuss the way these instruments may be used for the purpose of financing in the context of modern trade and industry.

The concept of musharakah and mudarabah envisaged in the books of Islamic Fiqh generally presumes that these contracts are meant for initiating a joint venture whereby all the partners participate in the business right from its inception and continue to be partners upto the end of the business when all the assets are liquidated. One can hardly find in the traditional books of Islamic Fiqh the concept of a running business where partners join and leave the enterprise without affecting in any way the continuity of the business. Obviously, the classical books of Islamic Fiqh were written in an environment where the large scale commercial enterprises were not in vogue and the commercial activities were not so complex as they are today. Therefore, they did not generally dwell upon the question of such a running business.

However, it does not mean that the concept of musharakah and mudarabah cannot be used for financing a running business. The concept of musharakah and mudarabah is based on some basic

principles. As long as these principles are fully complied with, the details of their application may vary from time to time. Let us have a look at these basic principles before entering the details:

(1) Financing through musharakah and mudarabah does never mean the advancing of money. It means to participation in the business and in the case of musharakah, sharing in the assets of the business to the extent of the ratio of financing.

(2) An investor / financier must share the loss incurred by the business to the extent of his financing.

(3) The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

(4) The loss suffered by each partner must be exactly in the proportion of his investment.

Keeping these broad principles in view, we proceed to see how musharakah and mudarabah can be used in different sectors of financing:

Project Financing

In the case of project financing, the traditional method of musharakah or mudarabah can be easily adopted. If the financier wants to finance the whole project, the form of mudarabah can come into operation. If investment comes from both sides, the form of musharakah can be adopted. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of musharakah and mudarabah can be brought into play according to the rules already discussed.

Since musharakah or mudarabah would have been effected from the very inception of the project, no problem with regard to the valuation of capital should arise. Similarly, the distribution of profits according to the normal accounting standards should not be difficult. However, if the financier wants to withdraw from the musharakah, while the other party wants to continue the business, the latter can purchase the share of the former at an agreed price. In this way the financier may get back the amount he has invested alongwith a profit, if the business has earned a profit. The basis for

determining the price of his share shall be discussed in detail later on (while discussing the financing of working capital).

On the other hand, the businessman can continue with his project, either on his own or by selling the first financier's share to some other person who can substitute the financier.

Since financial institutions do not normally want to remain partner of a specific project for good, they can sell their share to other partners of the project as aforesaid. If the sale of the share on one time basis is not feasible for the lack of liquidity in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier comes out of the project totally.

Securitization of Musharakah

Musharakah is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a musharakah certificate which represents his proportionate ownership in the assets of the musharakah, and after the project is started by acquiring substantial non-liquid assets, these musharakah certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the musharakah are still in liquid form (i.e., in the shape of cash or receivables or advances due from others).

For proper understanding of this point, it must be noted that subscribing to a musharakah is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest. The musharakah certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. one million each, have been issued. It means that the total worth of the

project is Rs. 100 million. If nothing has been purchased by this money, every certificate will represent Rs. one million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate is sold for more than Rs. one million, it will mean that Rs. one million are being sold in exchange for more than Rs. one million, which is not allowed in Shari'ah, because where money is exchanged for money, both must be equal. Any excess at either side is riba.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the musharakah certificates will represent the holders' proportionate ownership in these assets. Thus, in the above example, one certificate will stand for one hundredth share in these assets. In this case it will be allowed by the Shari'ah to sell these certificates in the secondary market for any price agreed upon between the parties which may be more than the face value of the certificate, because the subject matter of the sale is a share in the tangible assets and not in money only, therefore the certificates may be taken as any other commodities which may be sold with profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while rest of money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due on its customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of Shari'ah in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the musharakah certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi'i school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it

cannot be sold unless the non-liquid part of the business is separated and is sold independently.[1]

The Hanafi school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in the combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

Suppose, the musharakah project contains 40% non-liquid assets i.e. machinery, fixtures etc. and 60% liquid assets, i.e. cash and receivables. Now, each musharakah certificate having the face value of Rs. 100/- represents Rs. 60/- worth of liquid assets, and Rs. 40/- worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60. If it is sold at Rs. 110/- it will mean that Rs. 60 of the price are against Rs. 60/- contained in the certificate and Rs. 50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60/- or less, because in the case of Rs. 60/- it will not set off the amount of Rs. 60, let alone the other assets.

According to the Hanafi view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the non-liquid assets represent less than 50% in the whole, its trading according to the above formula is allowed.

However, most of the contemporary scholars, including those of Shafi'i school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%. Therefore, for a valid trading of the musharakah certificates acceptable to all schools, it is necessary that the portfolio of musharakah consists of non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50%, but the size of the non-liquid assets should not be negligible.

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[1] This view is based on the famous principle of "mudd al-'ajwah" explained in the traditional books of Islamic fiqh. See for example, al-Khattabi, *Ma'alim al-Sunan*, 5:23.

Financing of a Single Transaction

Musharakah and mudarabah can be used more easily for financing a single transaction. Apart from fulfilling the day to-day needs of small traders, these instruments can be employed for financing imports and exports. An importer can approach a financier to finance him for that single transaction of import alone on the basis of musharakah or mudarabah. The banks can also use these instruments for import financing. If the letter of credit has been opened without any margin, the form of mudarabah can be adopted, and if the L/C is opened with some margin, the form of musharakah or a combination of both will be relevant. After the imported goods are cleared from the port, their sale proceeds may be shared by the importer and the financier according to a pre-agreed ratio.

In this case, the ownership of the imported goods shall remain with the financier to the extent of the ratio of his investment. This musharakah can be restricted to an agreed term, and if the imported goods are not sold in the market up to the expiry of the term, the importer may himself purchase the share of the financier, making himself the sole owner of the goods. However, the sale in this case should take place at the market rate or at a price agreed between the parties on the date of sale, and not at pre-greed price at the time of entering into musharakah. If the price is pre-agreed, the financier cannot compel the client / importer to purchase it.

Similarly, musharakah will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well-known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of musharakah or mudarabah, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the L/C. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss which

may be caused due to any reason other than the negligence or misconduct of the exporter.

Financing of the Working Capital

Where finances are required for the working capital of a running business, the instrument of musharakah may be used in the following manner:

(1) The capital of the running business may be evaluated with mutual consent. It is already mentioned while discussing the traditional concept of musharakah that it is not necessary, according to Imam Malik, that the capital of musharakah is contributed in cash form. Non-liquid assets can also form part of the capital on the basis of evaluation. This view can be adopted here. In this way, the value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The musharakah may be effected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as "constructive liquidation" with mutual consent of the parties, because there is no specific prohibition in Shari'ah against it. It can also mean that the working partner has purchased the share of the financier in the assets of the business, and the price of his share has been determined on the basis of valuation, keeping in view the ratio of profit allocated for him according to the terms of musharakah.

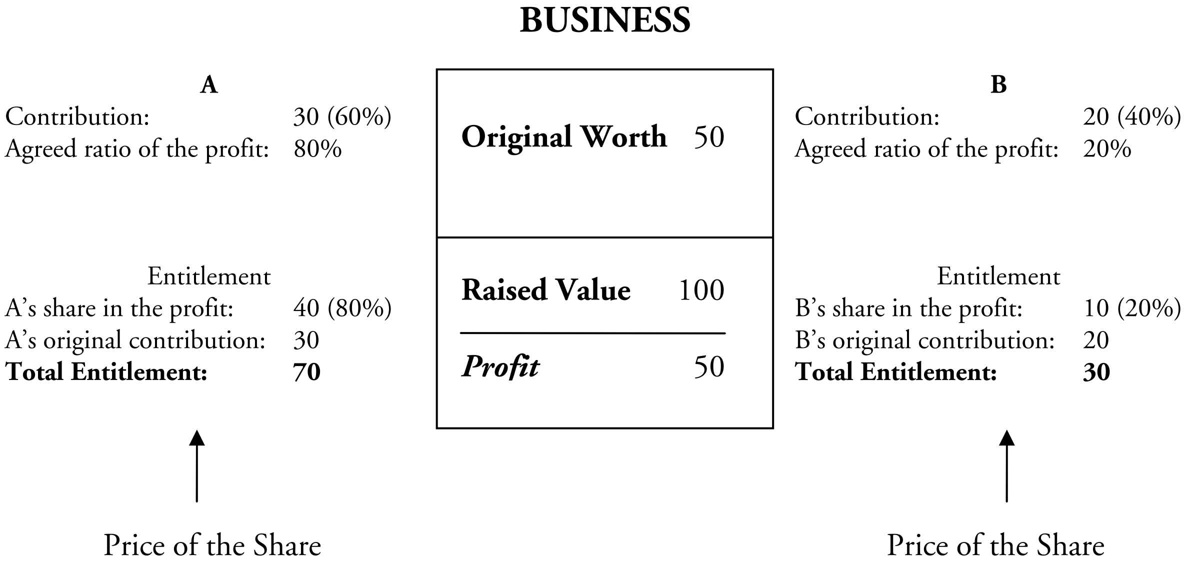
For example, the total value of the business of A is 30 units. B finances another 20 units, raising the total worth to 50 units; 40% having been contributed by B, and 60% by A. It is agreed that B shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of B is purchased by A, he should have paid to him 40 units,

because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit.

Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20-80, meaning thereby that 10 units will have been earned by B. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by B (being 40% of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units.

Figure 2


BUSINESS
A
Contribution: 30 (60%)
Agreed ratio of the profit: 80%
Entitlement
A's share in the profit: 40 (80%)
A's original contribution: 30
Total Entitlement: 70
Original Worth 50
Raised Value 100
Profit 50
B
Contribution: 20 (40%)
Agreed ratio of the profit: 20%
Entitlement
B's share in the profit: 10 (20%)
B's original contribution: 20
Total Entitlement: 30
Price of the Share
Price of the Share

Sharing in the Gross Profit Only

2. Financing on the basis of musharakah according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, musharakah may be applied in another way.

The major difficulties in these cases arise in the calculation of indirect expenses, like depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distribute able profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labor, electricity etc.) shall be borne by the musharakah. But since the industrialist is offering his machinery, building and staff to the musharakah voluntarily, the percentage of his profit may be increased to compensate him to some extent.

This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to musharakah, and in such a case the whole cost of these expenses cannot be imposed on the musharakah.

Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000/- per month. The factory sought finance of Rs. 5,000,000/- from a bank on the basis of musharakah for a term of one year. It means that after one year the musharakah will be terminated, and the profits accrued up to that point will be distributed between the parties according to the agreed ratio. While determining the profit, all direct expenses will be deducted from the income. The direct expenses may include the following:

1. the amount spent in purchasing raw material

2. the wages of the labor directly involved in processing the raw material
3. the expenses for electricity consumed in the process of ginning
4. the bills for other services directly rendered for the musharakah

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of the musharakah alone, because the musharakah will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year musharakah. Therefore, the whole cost of the building and the machinery cannot be borne by this short-term musharakah. What can be done at the most is that the depreciation caused to the building and the machinery during the term of the musharakah is included in its expenses. But in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the musharakah portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the musharakah fund irrespective of profit or loss accruing to the business.

The second option is that, instead of paying rent to the client, the ratio of his profit is increased.

From the point of view of Shari'ah, it may be justified on the analogy of mudarabah in services which is allowed in the view of Imam Ahmad bin Hanbal تعا اه ر.

Running Musharakah Account on the Basis of Daily Products

3. Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the musharakah or mudarabah modes of financing? Obviously, being a new phenomenon, no express answer to this question can be found in the classical works of Islamic Fiqh. However, keeping in view the basic principles of musharakah the following procedure may be suggested for this purpose:

(i) A certain percentage of the actual profit must be allocated for the management.

(ii) The remaining percentage of the profit must be allocated for the investors.

(iii) The loss, if any, should be borne by the investors only in exact proportion of their respective investments.

(iv) The average balance of the contributions made to the musharakah account calculated on the basis of daily products shall be treated as the share capital of the financier.

(v) The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the musharakah. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the musharakah portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on daily product basis.

Some contemporary scholars do not allow this method of calculating profits on the ground that it is just a conjectural method which does not reflect the actual profits really earned by a partner of the musharakah, because the business may have earned huge profits during a period when a particular investor had no money invested in the business at all, or had a very negligible amount invested, still, he will be treated at par with other investors who had huge amounts invested in the business during that period. Conversely, the business may have suffered a great loss during a period when a particular

investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was negligible.

This argument can be refuted on the ground that it is not necessary in a musharakah that a partner should earn profit on his own money only. Once a musharakah pool comes into existence, the profits accruing to the joint pool are earned by all the participants, regardless of whether their money is or is not utilized in a particular transaction. This is particularly true of the Hanafi School which does not deem it necessary for a valid musharakah that the monetary contributions of the partners are mixed up together. It means that if A has entered into a musharakah contract with B, but has not yet disbursed his money into the joint pool, he will still be entitled to a share in the profit of the transactions effected by B for the musharakah through his own money.[1] Although his entitlement to a share in the profit will be subject to the disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose, A and B entered into a musharakah to conduct a business of Rs. 100,000/-

They agreed that each one of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. A did not yet invest his Rs. 50,000/- into the joint pool. B found a profitable deal and purchased two air-conditions for the musharakah for Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10000/-. A contributed his share of Rs. 50,000/- after this deal. The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48000/- meaning thereby that this deal resulted in a loss of Rs. 2000/- Although the transaction effected by A's money brought loss of Rs. 2000/- while the profitable deal of air-conditions was financed entirely by B's money in which A had no contribution, yet A will be entitled to a share in the profit of the first deal. The loss of Rs. 2000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8000/-. This profit of Rs. 8000/- will be shared by both partners equally. It means that A

[1] See al-Kasani, *Bada'i' al-Sana'i'*, 6:54, 60.

will get Rs. 4000/-, even though the transaction effected by his money has suffered loss.

The reason is that once a musharakah contract is entered into by the parties, all the subsequent transactions effected for musharakah belong to the joint pool, regardless of whose individual money is utilized in them. Each partner is a party to each transaction by virtue of his entering into the contract of musharakah.

A possible objection to the above explanation may be that in the above example, A had undertaken to pay Rs. 50,000/- and it was known before hand that he will contribute a specified amount to the musharakah. But in the proposed running account of musharakah where the partners are coming in and going out every day, nobody has undertaken to contribute any specific amount. Therefore, the capital contributed by each partner is unknown at the time of entering into musharakah, which should render the musharakah invalid.

The answer to the above objection is that the classical scholars of Islamic Fiqh have different views about whether it is necessary for a valid musharakah that the capital is pre-known to the partners. The Hanafi scholars are unanimous on the point that it is not a pre-condition. Al-Kasani, the famous Hanafi jurist, writes:

واما العلم قدار رأس ا ال وقت العقد، فليس بشرط واز الشركة بالأموال عندنا. وعند الشافعي شرط ... ولنا أن ا هالة لا نع جواز العقد لعينها، بل لإفضاءها إ ا نازعة. وجهالة رأس ا ال وقت العقد لا تفضي إ ا نازعة ، لأنه يعلم مقداره ظاهرا وغالبا لأن الدراهم والدنا توزنان وقت الشراء فيعلم مقدارها فلا يؤدي إ جهالة مقدار الربح وقت القسمة

According to our Hanafi School, it is not a condition for the validity of musharakah that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that *jahalah* (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of musharakah does not lead to disputes, because it is

generally known when the commodities are purchased for the musharakah, therefore it does not lead to uncertainty in the profit at the time of distribution.[2]

It is, therefore, clear from the above that even if the amount of the capital is not known at the time of musharakah, the contract is valid. The only condition is that it should not lead to the uncertainty in the profit at the time of distribution. Distribution of profit on daily product basis fulfills this condition.

It is true that the concept of a running musharakah where the partners at times draw some amounts and at other times inject new money and the profits are calculated on daily products basis is not found in the classical books of Islamic Fiqh. But merely this fact cannot render a new arrangement invalid in Shari'ah, so far as it does not violate any basic principle of musharakah. In the proposed system, all the partners are treated at par. The profit of each partner is calculated on the basis of the period for which his money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool are generated by the joint utilization of different amounts contributed by the participants at different times. Therefore, if all of them agree with mutual consent to distribute the profits on daily products basis, there is no injunction of Shari'ah which makes it impermissible; rather, it is covered under the general guideline given by the Holy Prophet ﷺ in his famous hadith quoted in this book more than once:

ا سلمون على شروطهم الا شرطا احل حراما او حرم حلالا

All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

If distribution on daily products basis is not accepted, it will mean that no partner can draw any amount from, nor can he inject new amounts to the joint pool. Similarly, nobody will be able to subscribe to the joint pool except at the particular dates of the commencement of a new term. This arrangement is totally impracticable on the deposits side of the banks and financial

[2] Al-Kasani, *Bada'i' al-Sana'i'*, 6:63.

institutions where the accounts are debited and credited by the depositors many times a day. The rejection of the concept of the daily products will compel them to wait for months before they deposit their surplus money in a profitable account. This will hinder the utilization of savings for development of industry and trade, and will keep the wheel of financial activities jammed for long periods. There is no other solution for this problem except to apply the method of daily products for the calculation of profits, and since there is no specific injunction of Shari'ah against it, there is no reason why this method should not be adopted.

Some Objections on Musharakah Financing

Let us now examine some objections raised from practical point of view against using musharakah as a mode of financing.

Risk of Loss

It is argued that the arrangement of musharakah is more likely to pass on losses of the business to the financier bank or institution. This loss will be passed on to depositors also. The depositors, being constantly exposed to the risk of loss, will not want to deposit their money in the banks and financial institutions and thus their savings will either remain idle or will be used in transactions outside of the banking channels, which will not contribute to the economic development at national level.

This argument is, however, misconceived. Before financing on the basis of musharakah, the banks and financial institution will study the feasibility of the proposed business for which funds are needed. Even in the present system of interest-based loans the banks do not advance loans to each and every applicant. They study the potentials of the business and if they apprehend that the business is not profitable, they refuse to advance a loan. In the case of musharakah, they will have to carry out this study with more depth and precaution.

Moreover, no bank or financial institution can restrict itself to a single musharakah. There will always be a diversified portfolio of musharakah. If a bank has financed 100 of its clients on the basis of musharakah, after studying the feasibility of the proposal of each one of them, it is hardly conceivable that all of these musharakahs

or the majority of them will result in a loss. After taking proper measures and due care, what can happen at the most is that some and them make a loss. But on the other hand, the profitable musharakahs are expected to give more return than the interest-based loans, because the actual profit is supposed to be distributed between the client and the bank. Therefore, the musharakah portfolio, as a whole, is not expected to suffer loss, and the possibility of loss to the whole portfolio is merely a theoretical possibility which should not discourage the depositors. This theoretical possibility of loss in a financial institution is much less than the possibility of loss in a joint stock company whose business is restricted to a limited sector of commercial activities. Still, the people purchase its shares and the possibility of loss does not refrain them from investing in these shares. The case of the bank and financial institutions is much stronger, because their musharakah activities will be so diversified that any possible loss in one musharakah will be more than compensated by the profits earned in other musharakahs.

Apart from this, 'an Islamic economy must create a mentality which believes that any profit earned on money is the reward of bearing risks of the business. This risk may be minimized through expertise and diversifying the portfolio where it becomes a hypothetical or theoretical risk only. But there is no way to eliminate this risk totally. The one who wants to earn profit, must accept this minimal risk. Since this understanding is already there in the case of normal joint stock companies, nobody has ever raised the objection that the money of the shareholders is exposed to loss. The problem is created by the system which separates the banking and financing from the normal trade activities, and which has compelled the people to believe that banks and financial institutions deal in money and papers only, and that they have nothing to do with the actual results emerging in trade and industry. Therefore, it is argued that they deserve a fixed return in any case. This separation of financing sector from the sector of trade and industry has brought great harms to the economy at macro-level. Obviously, when we speak of Islamic banking, we never mean that it will follow this conventional system in each and every respect. Islam has its own values and principles which do not believe in separation of financing from trade and industry. Once this Islamic system is

understood, the people will invest in the financing sector, despite the theoretical risk of loss, more readily than they invest in the profitable joint stock companies.

Dishonesty

Another apprehension against musharakah financing is that the dishonest clients may exploit the instrument of musharakah by not paying any return to the financiers. They can always show that the business did not earn any profit. Indeed, they can claim that it has suffered a loss in which case not only the profit, but also the principal amount will be jeopardized.

It is, no doubt, a valid apprehension, especially in societies where corruption is the order of the day. However, solution to this problem is not as difficult as is generally believed or exaggerated.

If all the banks in a country are run on pure Islamic pattern with a careful support from the Central Bank and the government, the problem of dishonesty is not hard to overcome. First of all, a well-designed system of auditing should be implemented whereby the accounts of all the clients are fully maintained and properly controlled. It is already discussed that the profits may be calculated to the basis of gross margins only. It will reduce the possibility of disputes and misappropriation. However, if any misconduct, dishonesty or negligence is established against a client, he will be subjected to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specified period.

These steps will serve as strong deterrent against concealing the actual profits or committing any other act of dishonesty. Otherwise also, the clients of the banks cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a possibility of some cases where dishonest clients may succeed in their evil designs, but the punitive steps and the general atmosphere of the business will gradually reduce the number of such cases (Even in an interest-based economy, the defaulters have always been creating the problem of bad debts) But it should not be taken as a justification, or as an excuse, for rejecting the whole system of musharakah.

Undoubtedly, the apprehension of dishonesty is more severe for the Islamic Banks and Financial institutions working in isolation from the main stream of conventional banks. They have not much support from their respective governments and central Banks. They cannot change the system, nor can they impose their own laws and regulations. However, they should not forget that they are not just commercial institutions. They have been established to introduce a new system of banking which has its own philosophy. They are duty bound to promote this new system, even if they apprehend that it will reduce the size of their profits to some extent. Therefore, they should start using the instrument of musharakah, at least on a selective basis. Each and every bank has a number of clients whose integrity is beyond all doubts. The Islamic banks should, at least, start financing them on the basis of true musharakah. It will help setting good precedents in the market and induce others to follow suit. Moreover, there are some sectors of financing where musharakah can be used easily. For example, the use of musharakah instrument in financing exports has not much room for dishonesty. The exporter has a specific order from abroad. The prices are agreed. The cost is not difficult to determine. Payments are normally secured by a letter of credit. The payments are made through the bank itself. There is no reason in such cases why the musharakah arrangement should not be adopted. Similarly, financing of imports may also be designed on the basis of musharakah with some precautions, as explained earlier in this chapter.

Secrecy of the Business

Another criticism against musharakah is that, by making the financier a partner in the business of the client, it may disclose the secrets of the business to the financier, and through him to other traders.

However, the solution to this problem is very easy. The client, while entering into the musharakah, may put a condition that the financier will not interfere with the management affairs, and he will not disclose any information about the business to any person without prior permission of the client. Such agreements of maintaining secrecy are always honored by the prestigious

institutions, especially by the banks and financial institutions whose entire business is based on confidentiality.

Clients' Unwillingness to Share Profits

Many a time, it is mentioned that the clients are not willing to share with the Banks the actual profits of their business. The reluctance is based on two reasons:

1. They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why should they (the clients) share the fruit of their labour with the Bank who merely provides funds. The Clients also argue that conventional banks are content with a meagre rate of interest and so should be the Islamic Banks.
2. Even if the above was not a factor, the Clients are afraid to reveal their true profits to the Banks, lest the information is also passed on to the tax authorities and Clients' tax liability increases.

The solution to the first part, though not easy, is not difficult or impossible either. Such Clients need to be convinced and persuaded that borrowing on interest is a cardinal sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need, by any stretch of imagination. By making a legitimate arrangement for obtaining funds for their business, by way of musharakah, not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

In respect of the second factor, all that can be said is that in some muslim countries, rate of taxation are indeed prohibitive and unjust. Islamic Banks as well as their Clients must lobby with the governments and struggle to change the laws which hamper the progress towards Islamic banking. The governments should also try to appreciate the fact that if rates of taxation are reasonable and if the tax-payers are convinced that they will benefit by honestly paying their taxes, this would increase, and not decrease, government revenues.

Diminishing Musharakah

Another form of musharakah, developed in the near past, is 'diminishing musharakah'. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

The diminishing musharakah based on the above concept has taken different shapes in different transactions. Some examples are given below:

1. It has been used mostly in house financing. The client wants to purchase a house for which he does not have adequate funds. He approaches the financier who agrees to participate with him in purchasing the required house. 20% of the price is paid by the client and 80% of the price by the financier. Thus the financier owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time the share of financier is further divided in eight equal units, each unit representing 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the financier by paying 1/10th of the price of the house. It reduces the share of the financier from 80% to 70%. Hence, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit increasing his share in the property to 40% and reducing the share of the financier to 60% and consequentially reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the

financier reducing the share of the financier to 'zero' and increasing his own share to 100%.

This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.

2. 'A' wants to purchase a taxi to use it for offering transport services to passengers and to earn income through fares recovered from them, but he is short of funds. 'B' agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly. 80% of the price is paid by 'B' and 20% is paid by 'A'. After the taxi is purchased, it is employed to provide transport to the passengers whereby the net income of Rs. 1000/- is earned on daily basis. Since 'B' has 80% share in the taxi it is agreed that 80% of the fare will be given to him and the rest of 20% will be retained by 'A' who has a 20% share in the taxi. It means that Rs. 800/- is earned by 'B' and Rs. 200/- by 'A' on daily basis. At the same time the share of 'B' is further divided into eight units. After three months 'A' purchases one unit from the share of 'B'. Consequently the share of 'B' is reduced to 70% and share of 'A' is increased to 30% meaning thereby that as from that date 'A' will be entitled to Rs. 300/- from the daily income of the taxi and 'B' will earn Rs. 700/-. This process will go on until after the expiry of two years, the whole taxi will be owned by 'A' and 'B' will take back his original investment along with income distributed to him as aforesaid.
3. 'A' wishes to start the business of ready-made garments but lacks the required funds for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of musharakah. The proportion of profit allocated for each one of them is expressly agreed upon. But at the same time 'B's share in the business is divided to six equal units and 'A' keeps purchasing these units on gradual basis until after the end of two years 'B' comes out of the business, leaving its exclusive

ownership to 'A'. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him.

Analyzed from the Shari'ah point of view this arrangement is composed of different transactions which come to play their role at different stages. Therefore, each one of the foregoing three forms of diminishing musharakah is discussed below in the light of the Islamic principles:

House Financing on the Basis of Diminishing Musharakah

The proposed arrangement is composed of the following transactions:

1. To create joint ownership in the property (Shirkat-al-Milk).
2. Giving the share of the financier to the client on rent.
3. Promise from the client to purchase the units of share of the financier.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental according to the remaining share of the financier in the property.

Let me discuss each ingredient of the arrangement in a greater detail.

i) The first step in the above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of this chapter that 'Shirkat-al-Milk' (joint ownership) can come into existence in different ways including joint purchase by the parties. This has been expressly allowed by all schools of Islamic jurisprudence.[3] Therefore no objection can be raised against creating this joint ownership.

ii) The second part of the arrangement is that the financier leases his share in the house to his client and charges rent from him.

[3] See for example *Radd al-Muhtar*, 3:364–365.

This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifah and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Malik and Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of 'ijarah'. [4]

iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to the third party.[5]

It is clear from the foregoing three points that each one of the transactions mentioned hereinabove is allowed per se, but the question is whether this transaction may be combined in a single arrangement. The answer is that if all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in Shari'ah, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another. However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be one sided promise from the client, firstly, to take share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the house at different stages. This leads us to the fourth issue, which is, the enforceability of such a promise.

iv) It is generally believed that a promise to do something creates only a moral obligation on the promisor which cannot be enforced through courts of law. However, there are a number of

[4] See Ibn Qudamah, *Al-Mughni*, 6:137; and *Radd al-Muhtar*, 6:47, 48.

[5] See *Radd al-Muhtar*, 3:365.

Muslim jurists who opine that promises are enforceable, and the court of law can compel the promisor to fulfil his promise, especially, in the context of commercial activities. Some Maliki and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need. The Hanafi jurists have adopted this view with regard to a particular sale called 'bai-bilwafa'. This bai-bilwafa is a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have opined that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale, the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "قد عل ا واعيد لازمة اجة الناس" (the promise can be made enforceable at the time of need).

Even if the promise has been made before effecting the first sale, after which the sale has been effected without a condition, it is also allowed by certain Hanafi jurists.[6]

One may raise an objection that if the promise of resale has been taken before entering into an actual sale, it practically amounts to putting a condition on the sale itself, because the promise is understood to have been entered into between the parties at the time of sale, and therefore, even if the sale is without an express condition, it should be taken as conditional because a promise in an express term has preceded it.

This objection can be answered by saying that there is a big difference between putting a condition in the sale and making a separate promise without making it a condition. If the condition is expressly mentioned at the time of sale, it means that the sale will be valid only if the condition is fulfilled, meaning thereby that if the condition is not fulfilled in future, the present sale will become

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[6] See *Jami' al-Fusulain*, 2:237 and *Radd al-Muhtar*, 4:135.

void. This makes the transaction of sale contingent on a future event which may or may not occur. It leads to uncertainty (gharar) in the transaction which is totally prohibited in Shari‘ah.

Conversely, if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale cannot be held to be contingent or conditional with fulfilling of the promise made. It will take effect irrespective of whether or not the promisor fulfils his promise. Even if the promisor backs out of his promise, the sale will remain effective. The most the promise can do is to compel the promisor through court of law to fulfil his promise and if the promisor is unable to fulfil the promise, the promise can claim actual damages he has suffered because of the default.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced.

On the basis of this analysis, diminishing musharakah may be used for House Financing with following conditions:

a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the client. This is allowed because, as explained in the relevant chapter, ijarah can be effected for a future date. At the same time the client may sign one-sided promise to purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

b) At the time of the purchase of each unit, sale must be effected by the exchange of offer and acceptance at that particular date.

c) It will be preferable that the purchase of different units by the client is effected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.

Diminishing Musharakah for Carrying Business of Services

The second example given above for diminishing musharakah is the joint purchase of a taxi run for earning income by using it as a hired vehicle. This arrangement consists of the following ingredients:

i) Creating joint ownership in a taxi in the form of Shirkah al-Milk. As already stated this is allowed in Shari'ah.

ii) Musharakah in the income generated through the services of taxi. It is also allowed as mentioned earlier in this chapter.

iii) Purchase of different units of the share of the financier by the client. This is again subject to the conditions already detailed in the case of House financing. However, there is a slight difference between House financing and the arrangement suggested in this second example. The taxi, when used as a hired vehicle, normally depreciates in value over time, therefore, depreciation in the value of taxi must be kept in mind while determining the price of different units of the share of the financier.

Diminishing Musharakah in Trade

The third example of diminishing musharakah as given above is that the financier contributes 60% of the capital for launching a business of ready made garments, for example. This arrangement is composed of two ingredients only:

1) In the first place, the arrangement is simply a musharakah whereby two partners invest different amounts of capital in a joint enterprise. This is obviously permissible subject to the conditions of musharakah already spelled out earlier in this chapter.

2) Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of Shari'ah regarding this promise are the same as explained in the case of House financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering into musharakah, it will practically mean that the client has ensured the principal invested by the financier with or without profit, which is strictly prohibited in the case of musharakah. Therefore, there are two options for the financier about fixing the price of his units to be

purchased by the client. One option is that he agrees to sell the units on the basis of valuation of the business at the time of the purchase of each unit. If the value of the business has increased, the price will be higher and if it has decreased the price will be less. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at the price fixed by him before hand.

Although both these options are available according to the principles of Shari'ah, the second option does not seem to be feasible for the financier, because it would lead to injecting new partners in the musharakah which will disturb the whole arrangement and defeat the purpose of diminishing musharakah in which the financier wants to get his money back within a specified period. Therefore, in order to implement the objective of diminishing musharakah, only the first option is practical.

5

Murabahah

Introduction

Most of the Islamic banks and financial institutions are using *murabahah* as an Islamic mode of financing, and most of their financing operations are based on murabahah. That is why this term has been taken in the economic circles today as a method of banking operations, while the original concept of murabahah is different from this assumption.

"Murabahah" is, in fact, a term of Islamic Fiqh and it refers to a particular kind of sale having nothing to do with financing in its original sense. If a seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost, it is called a murabahah transaction. The basic ingredient of murabahah is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage.

The payment in the case of murabahah may be at spot, and may be on a subsequent date agreed upon by the parties. Therefore, murabahah does not necessarily imply the concept of deferred payment, as generally believed by some people who are not acquainted with the Islamic jurisprudence and who have heard about murabahah only in relation with the banking transactions.

Murabahah, in its original Islamic connotation, is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in murabahah expressly tells the purchaser how much cost

he has incurred and how much profit he is going to charge in addition to the cost.

If a person sells a commodity for a lump sum price without any reference to the cost, this is not a murabahah, even though he is earning some profit on his cost because the sale is not based on a "cost-plus" concept. In this case, the sale is called "*musawamah*."

This is the actual sense of the term "murabahah" which is a sale, pure and simple. However, this kind of sale is being used by the Islamic banks and financial institutions by adding some other concepts to it as a mode of financing. But the validity of such transactions depends on some conditions which should be duly observed to make them acceptable in Shari'ah.

In order to understand these conditions correctly, one should, in the first instance, appreciate that murabahah is a sale with all its implications, and that all the basic ingredients of a valid sale should be present in murabahah also. Therefore, this discussion will start with some fundamental rules of sale without which a sale cannot be held as valid in Shari'ah. Then, we shall discuss some special rules governing the sale of murabahah in particular, and in the end the correct procedure for using the murabahah as an acceptable mode of financing will be explained.

An attempt has been made to reduce the detailed principles into concise notes in the shortest possible sentences, so that the basic points of the subject may be grasped at in one glance, and may be preserved for easy reference.

Some Basic Rules of Sale

'Sale' is defined in Shari'ah as 'the exchange of a thing of value by another thing of value with mutual consent'. Islamic jurisprudence has laid down enormous rules governing the contract of sale, and the Muslim jurists have written a large number of books, in a number of volumes, to elaborate them in detail. What is meant here is to give a summary of only those rules which are more relevant to the transactions of murabahah as carried out by the financial institutions:

Rule 1. The subject of sale must be existing at the time of sale.

Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to Shari'ah.

> **Example:** A sells the unborn calf of his cow to B. The sale is void.

Rule 2. The subject of sale must be in the ownership of the seller at the time of sale.
Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void.

> **Example:** A sells to B a car which is presently owned by C, but A is hopeful that he will buy it from C and shall deliver it to B subsequently. The sale is void, because the car was not owned by A at the time of sale.

Rule 3. The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person.
"Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control, and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction.

> **Examples:**
> **(i)** A has purchased a car from B. B has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before taking its delivery from B, the sale is void.
> **(ii)** A has purchased a car from B. B, after identifying the Car has placed it in a garage to which A has free access and B has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the Car has passed on to A.. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

> **Explanation 1:**
> The gist of the rules mentioned in paragraphs 1 to 3 is that a person cannot sell a commodity unless:

(a) It has come into existence.
(b) It is owned by the seller.
(c) It is in the physical or constructive possession of the seller.

Explanation 2:
There is a big difference between an actual sale and a mere promise to sell. The actual sale cannot be effected unless the above three conditions are fulfilled. However one can promise to sell something which is not yet owned or possessed by him. This promise initially creates only a moral obligation on the promisor to fulfil his promise, which is normally not justifiable. Nevertheless, in certain situations, specially where such promise has burdened the promise with some liability, it can be enforceable through the courts of law. In such cases the court may force the promisor to fulfil his promise, i.e. to effect the sale, and if he fails to do so, the court may order him to pay the promise the actual damages he has incurred due to the default of the promisor.[1]

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.

Exception:
The rules mentioned in paragraphs 1 to 3 are relaxed with respect to two types of sale, namely:
(a) Bai' Salam
(b) Istisna'

The rules of these two types will be discussed later in a separate chapter.

Rule 4. The sale must be instant and absolute.
Thus a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to effect a valid sale, they will

[1] Resolution no. 2, 3 of the Fifth Session of the Islamic Fiqh Academy held in Kuwait in the year 1409 AH. See مجلة مجمع الفقه الإسلامي، العدد الخامس 2:1599.

have to effect it afresh when the future date comes or the contingency actually occurs.

Examples:

(a) A says to B on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date.

(b) A says to B, "If party X wins the elections, my car stands sold to you". The sale is void, because it is contingent on a future event.

Rule 5. The subject of sale must be a property of value.

Thus, a thing having no value according to the usage of trade cannot be sold or purchased.

Rule 6. The subject of sale should not be a thing which is not used except for a haram purpose, like pork, wine etc.

Rule 7. The subject of sale must be specifically known and identified to the buyer.

Explanation:

The subject of sale may be identified either by pointation or by detailed specification which can distinguish it from other things not sold.

Example:

There is a building comprising a number of apartments built in the same pattern. A, the owner of the building says to B, "I sell one of these apartments to you"; B accepts. The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

Rule 8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

Example: A sells his car stolen by some anonymous person and the buyer purchases it under the hope that he will manage to take it back. The sale is void.

Rule 9. The certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.

Example: A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55". B agrees. The price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

Rule 10. The sale must be unconditional. A conditional sale is invalid, unless the condition is recognized as a part of the transaction according to the usage of trade.

Examples:
(1) A buys a car from B with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.
(2) A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

Bai' Mu'ajjal (Sale on Deferred Payment Basis)

1. A sale in which the parties agree that the payment of price shall be deferred is called a "*Bai' Mu'ajjal*".

2. Bai' Mu'ajjal is valid if the due date of payment is fixed in an unambiguous manner.

3. The due time of payment can be fixed either with reference to a particular date, or by specifying a period, like three months, but it cannot be fixed with reference to a future event the exact date of which is unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void.

4. If a particular period is fixed for payment, like one month, it will be deemed to commence from the time of delivery, unless the parties have agreed otherwise.

5.. The deferred price may be more than the cash price, but it must be fixed at the time of sale.

6. Once the price is fixed, it cannot be decreased in case of earlier payment, nor can it be increased in case of default.

7. In order to pressurize the buyer to pay the installments promptly, the buyer may be asked to promise that in case of default, he will donate some specified amount for a charitable purpose. In this case the seller may receive such amount from the buyer, not to make it a part of his income, but to use it for a charitable purpose on behalf of the buyer. The detailed discussion on this subject will be found later in this chapter.

8. If the commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately.

9. In order to secure the payment of price, the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets.

10. The buyer can also be asked to sign a promissory note or a bill of exchange, but the note or the bill cannot be sold to a third party at a price different from its face value.

Murabahah

1. Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit or mark-up thereon.

2. The profit in murabahah can be determined by mutual consent, either in lump sum or through an agreed ratio of profit to be charged over the cost.

3. All the expenses incurred by the seller in acquiring the commodity like freight, custom duty etc. shall be included in the cost price and the mark-up can be applied on the aggregate cost. However, recurring expenses of the business like salaries of the staff, the rent of the premises etc. cannot be included in the cost of an individual transaction. In fact, the profit claimed over the cost takes care of these expenses.

4. Murabahah is valid only where the exact cost of a commodity can be ascertained. If the exact cost cannot be ascertained, the commodity cannot be sold on murabahah basis. In this case the commodity must be sold on *musawamah* (bargaining) basis i.e.

without any reference to the cost or to the ratio of profit / mark-up. The price of the commodity in such cases shall be determined in lump sum by mutual consent.

> **Example (1)** A purchased a pair of shoes for Rs. 100/-. He wants to sell it on murabahah with 10% mark-up. The exact cost is known. The murabahah sale is valid.
>
> **Example (2)** A purchased a ready - made suit with a pair of shoes in a single transaction, for a lump sum price of Rs. 500/-. A can sell the suit including shoes on murabahah. But he cannot sell the shoes separately on murabahah, because the individual cost of the shoes is unknown. If he wants to sell the shoes separately, he must sell it at a lump sum price without reference to the cost or to the mark-up.

Murabahah as a Mode of Financing

Originally, murabahah is a particular type of sale and not a mode of financing. The ideal mode of financing according to Shari'ah is mudarabah or musharakah which have been discussed in the first chapter. However, in the perspective of the current economic set up, there are certain practical difficulties in using mudarabah and musharakah instruments in some areas of financing. Therefore, the contemporary Shari'ah experts have allowed, subject to certain conditions, the use of the murabahah on deferred payment basis as a mode of financing. But there are two essential points which must be fully understood in this respect:

1. It should never be overlooked that, originally, murabahah is not a mode of financing. It is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where mudarabah or musharakah are not practicable.

2. The second important point is that the murabahah transaction does not come into existence by merely replacing the word of "interest" by the words of "profit" or "mark-up". Actually, murabahah as a mode of finance, has been allowed by the Shari'ah scholars with some conditions. Unless these conditions are fully

observed, murabahah is not permissible. In fact, it is the observance of these conditions which can draw a clear line of distinction between an interest-bearing loan and a transaction of murabahah. If these conditions are neglected, the transaction becomes invalid according to Shari'ah.

Basic Features of Murabahah Financing

1. Murabahah is not a loan given on interest. It is the sale of a commodity for a deferred price which includes an agreed profit added to the cost.

2. Being a sale, and not a loan, the murabahah should fulfil all the conditions necessary for a valid sale, especially those enumerated earlier in this chapter.

3. Murabahah cannot be used as a mode of financing except where the client needs funds to actually purchase some commodities. For example, if he wants funds to purchase cotton as a raw material for his ginning factory, the Bank can sell him the cotton on the basis of murabahah. But where the funds are required for some other purposes, like paying the price of commodities already purchased by him, or the bills of electricity or other utilities or for paying the salaries of his staff, murabahah cannot be effected, because murabahah requires a real sale of some commodities, and not merely advancing a loan.

4. The financier must have owned the commodity before he sells it to his client.

5. The commodity must come into the possession of the financier, whether physical or constructive, in the sense that the commodity must be in his risk, though for a short period.

6. The best way for murabahah, according to Shari'ah, is that the financier himself purchases the commodity and keeps it in his own possession, or purchases the commodity through a third person appointed by him as agent, before he sells it to the customer. However, in exceptional cases, where direct purchase from the supplier is not practicable for some reason, it is also allowed that he makes the customer himself his agent to buy the commodity on his behalf. In this case the client first purchases the commodity on behalf of his financier and takes its possession as such. Thereafter, he purchases the commodity from the financier for a deferred price.

His possession over the commodity in the first instance is in the capacity of an agent of his financier. In this capacity he is only a trustee, while the ownership vests in the financier and the risk of the commodity is also borne by him as a logical consequence of the ownership. But when the client purchases the commodity from his financier, the ownership, as well as the risk, is transferred to the client.

7. As mentioned earlier, the sale cannot take place unless the commodity comes into the possession of the seller, but the seller can promise to sell even when the commodity is not in his possession. The same rule is applicable to murabahah.

8. In the light of the aforementioned principles, a financial institution can use the murabahah as a mode of finance by adopting the following procedure:

> **Firstly:** The client and the institution sign an over-all agreement whereby the institution promises to sell and the client promises to buy the commodities from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit upto which the facility may be availed.
> **Secondly:** When a specific commodity is required by the customer, the institution appoints the client as his agent for purchasing the commodity on its behalf, and an agreement of agency is signed by both the parties.
> **Thirdly:** The client purchases the commodity on behalf of the institution and takes its possession as an agent of the institution.
> **Fourthly:** The client informs the institution that he has purchased the commodity on his behalf, and at the same time, makes an offer to purchase it from the institution.
> **Fifthly:** The institution accepts the offer and the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client.

All these five stages are necessary to effect a valid murabahah. If the institution purchases the commodity directly from the supplier (which is preferable) it does not need any agency agreement. In this case, the second phase will be dropped and at the third stage the institution itself will purchase the commodity from the supplier,

and the fourth phase will be restricted to making an offer by the client.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage. This is the only feature of murabahah which can distinguish it from an interest-based transaction. Therefore, it must be observed with due diligence at all costs, otherwise the murabahah transaction becomes invalid according to Shari'ah.

9. It is also a necessary condition for the validity of murabahah that the commodity is purchased from a third party. The purchase of the commodity from the client himself on 'buy back' agreement is not allowed in Shari'ah. Thus murabahah based on 'buy back' agreement is nothing more than an interest based transaction.

10. The above mentioned procedure of the murabahah financing is a complex transaction where the parties involved have different capacities at different stages.

(a) At the first stage, the institution and the client promise to sell and purchase a commodity in future. This is not an actual sale. It is just a promise to effect a sale in future on murabahah basis. Thus at this stage the relation between the institution and the client is that of a promisor and a promise.

(b) At the second stage, the relation between the parties is that of a principal and an agent.

(c) At the third stage, the relation between the institution and the supplier is that of a buyer and seller.

(d) At the fourth and fifth stage, the relation of buyer and seller comes into operation between the institution and the client, and since the sale is effected on deferred payment basis, the relation of a debtor and creditor also emerges between them simultaneously.

All these capacities must be kept in mind and must come into operation with all their consequential effects, each at its relevant stage, and these different capacities should never be mixed up or confused with each other.

11. The institution may ask the client to furnish a security to its satisfaction for the prompt payment of the deferred price. He may also ask him to sign a promissory note or a bill of exchange, but it must be after the actual sale takes place, i.e. at the fifth stage mentioned above. The reason is that the promissory note is signed

by a debtor in favour of his creditor, but the relation of debtor and creditor between the institution and the client begins only at the fifth stage, whereupon the actual sale takes place between them.

12. In the case of default by the buyer in the payment of price at the due date, the price cannot be increased. However, if he has undertaken, in the agreement to pay an amount for a charitable purpose, as mentioned in para 7 of the rules of Bai' Mu'ajjal, he shall be liable to pay the amount undertaken by him. But the amount so recovered from the buyer shall not form part of the income of the seller / the financier. He is bound to spend it for a charitable purpose on behalf of the buyer, as will be explained later in detail.

Some Issues Involved in Murabahah

So far the basic concept of murabahah has been explained. Now, it is proposed to discuss some relevant issues with reference to the underlying Islamic principles and their practical applicability in murabahah transaction, because without correct understanding of these issues, the concept may remain ambiguous and its practical application may be susceptible to errors and misconceptions.

Different Pricing for Cash and Credit Sales

The first and foremost question about murabahah is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The financier purchases the commodity on cash payment and sells it to the client on credit. While selling the commodity on credit, he takes into account the period in which the price is to be paid by the client and increases the price accordingly. The longer the maturity of the murabahah payment, the higher the price. Therefore the price in a murabahah transaction, as practiced by the Islamic banks, is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a murabahah transaction on deferred payment basis. The question arises as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. Some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest

charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the murabahah transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by the conventional banks.

This argument, which seems to be logical in appearance, is based on a misunderstanding about the principles of Shari'ah regarding the prohibition of riba. For the correct comprehension of the concept the following points must be kept in view.

The modern capitalist theory does not differentiate between money and commodity in so far as commercial transactions are concerned. In the matter of exchange, money and commodity both are treated at par. Both can be traded in. Both can be sold at whatever price the parties agree upon. One can sell one dollar for two dollars on the spot as well as on credit, just as he can sell a commodity valuing one dollar for two dollars. The only condition is that it should be with mutual consent.

The Islamic principles, however, do not subscribe to this theory. According to Islamic principles, money and commodity have different characteristics and therefore, they are treated differently. The basic points of difference between money and commodity are the following:

(a) Money has no intrinsic utility. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring some goods or services. The commodities, on the other hand, have intrinsic utility. They can be utilized directly without exchanging them for some other thing.

(b) The commodities can be of different qualities, while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all the units of money, of same denomination, are 100% equal to each other. An old and dirty note of Rs. 1000/- has the same value as a brand new note of Rs. 1000/-, unlike the commodities which may have different qualities, and obviously an old and used car may be much less in value than a brand new car.

(c) In commodities, the transaction of sale and purchase is effected on a particular individual commodity or, at least, on the commodities having particular specifications. If A has purchased a particular car by pin-pointing it and seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the

delivery of another car, though of the same type or quality. This can only be done if the purchaser agrees to it which implies that the earlier transaction is cancelled and a new transaction on the new car is effected by mutual consent.

Money, on the contrary, cannot be pin-pointed in a transaction of exchange. If A has purchased a commodity from B by showing him a particular note of Rs. 1000/- he can still pay him another note of the same denomination, while B cannot insist that he will take the same note as was shown to him.

Keeping these differences in view, Islam has treated money and commodities differently. Since money has no intrinsic utility, but is only a medium of exchange which has no different qualities, the exchange of a unit of money for another unit of the same denomination cannot be effected except at par value. If a currency note of Rs. 1000/- is exchanged for another note of Pakistani Rupees, it must be of the value of Rs. 1000/- The price of the former note can neither be increased nor decreased from Rs. 1000/- even in a spot transaction, because the currency note has no intrinsic utility nor a different quality (recognized legally), therefore any excess on either side is without consideration, hence not allowed in Shari‘ah. As this is true in a spot exchange transaction, it is also true in a credit transaction where there is money on both sides, because if some excess is claimed in a credit transaction (where money is exchanged for money) it will be against nothing but time.

The case of the normal commodities is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of the purchaser. If the purchaser accepts to buy it at that increased price, the excess charged from him is quite permissible for the seller. When he can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will.

It is sometimes argued that the increase of price in a cash transaction is not based on the deferred payment, therefore it is

permissible while in a sale based on deferred payment, the increase is purely against time which makes it analogous to interest. This argument is again based on the misconception that whenever price is increased taking the time of payment into consideration, the transaction comes within the ambit of interest. This presumption is not correct. Any excess amount charged against late payment is riba only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity which has intrinsic utility may charge a higher price and the purchaser may agree to pay it due to various reasons, for example:

(a) His shop is nearer to the buyer who does not want to go to the market which is not so near.
(b) The seller is more trust-worthy for the purchaser than others, and the purchaser has more confidence in him that he will give him the required thing without any defect.
(c) The seller gives him priority in selling commodities having more demand.
(d) The atmosphere of the shop of the seller is cleaner and more comfortable than other shops,
(e) The seller is more courteous in his dealings than others.

These and similar other considerations play their role in charging a higher price from the customer. In the same way, if a seller increases the price because he allows credit to his client, it is not prohibited by Shari‘ah if there is no cheating and the purchaser accepts it with open eyes, because whatever the reason of increase, the whole price is against a commodity and not against money. It is true that, while increasing the price of the commodity, the seller has kept in view the time of its payment, but once the price is fixed, it relates to the commodity, and not to the time. That is why if the purchaser fails to pay at the stipulated time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.

To put it another way, since money can only be traded in at par value, as explained earlier, any excess claimed in a credit transaction (of money in exchange of money) is against nothing but time. That is why if the debtor is allowed more time at maturity, some more money is claimed from him. Conversely, in a credit sale of a commodity, time is not the exclusive consideration while fixing the price. The price is fixed for commodity, not for time. However, time may act as an ancillary factor to determine the price of the commodity, like any other factor from those mentioned above, but once this factor has played its role, every part of the price is attributed to the commodity.

The upshot of this discussion is that when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and credit transactions. Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money.

This position is accepted unanimously by all the four schools of Islamic law and the majority of the Muslim jurists. They say that if a seller determines two different prices for cash and credit sales, the price of the credit sale being higher than the cash price, it is allowed in Shari‘ah. The only condition is that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of the transaction. For example, it is allowed for the seller, at the time of bargaining, to say to purchaser, “If you purchase the commodity on cash payment, the price would be Rs. 100/- and if you purchase it on a credit of six months, the price would be Rs. 110/-.” But the purchaser shall have to select either of the two options. He should say that he would purchase it on credit for Rs. 110/-. Thus, at the time of actual sale, the price will be known to both parties. [2]

However, if either of the two options is not determined in specific terms, the sale will not be valid. This may happen in those installment sales in which different prices are claimed for different

[2] See Ibn Qudamah, *al-Mughni*, 4:290; al-Sarakhsi, *al-Mabsut*, 13:8; al-Dasuqi, 3:58; and *Mughni al-Muhtaj*, 2:31.

maturities. In this case the seller draws a schedule of prices according to schedule of payment. For example, Rs. 1000/- are charged for the credit of 3 months Rs. 1100/- for the credit of 6 months, Rs. 1200/- for 9 month and so on. The purchaser takes the commodity without specifying the option he will exercise, on the assumption that he will pay the price in future according to his convenience. This transaction is not valid, because the time of payment, as well as the price, is not determined. But if he chooses one of this options specifically and says, for example, that he purchases the commodity on 6 months credit with a price of 1100/- the sale will be valid.

Another point must be noted here. What has been allowed above is that the price of the commodity in a credit sale is fixed at more than the cash price. But if the sale has taken place at cash price, and the seller has imposed a condition that in case of late payment, he will charge 10% per annum as a penalty or as interest, this is totally prohibited; because what is being charged is not a part of the price; it is an interest charged on a debt.

The practical difference between the two situations is that where the additional amount is a part of the price, it may be charged on a one time basis only. If the purchaser fails to pay it on time, the seller cannot charge another additional amount. The price will remain the same without any addition. Conversely, where the additional amount is not a part of the price it will keep increasing with the period of default.

The Use of Interest-Rate as Benchmark

Many institutions financing by way of murabahah determine their profit or mark-up on the basis of the current interest rate, mostly using LIBOR (Inter-bank offered rate in London) as the criterion. For example, if LIBOR is 6%, they determine their mark-up on murabahah equal to LIBOR or some percentage above LIBOR. This practice is often criticized on the ground that profit based on a rate of interest should be as prohibited as interest itself.

No doubt, the use of the rate of interest for determining a halal profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of

interest, even this apparent resemblance should be avoided as far a possible. But one should not ignore the fact that the most important requirement for validity of murabahah is that it is a genuine sale with all its ingredients and necessary consequences. If a murabahah transaction fulfils all the conditions enumerated in this chapter, merely using the interest rate as a benchmark for determining the profit of murabahah does not render the transaction as invalid, haram or prohibited, because the deal itself does not contain interest. The rate of interest has been used only as an indicator or as a benchmark. In order to explain the point, let me give an example.

A and B are two brothers. A trades in liquor which is totally prohibited in Shari'ah. B, being a practicing Muslim dislikes the business of A and starts the business of soft drinks, but he wants his business to earn as much profit as A earns through trading in liquor, therefore he resolves that he will charge the same rate of profit from his customers as A charges over the sale of liquor. Thus he has tied up his rate of profit with the rate used by A in his prohibited business. One may question the propriety of his approach in determining the rate of his profit, but obviously no one can say that the profit charged by him in his halal business is haram, because he has used the rate of profit of the business of liquor as a benchmark.

Similarly, so far as the transaction of murabahah is based on Islamic principles and fulfils all its necessary requirements, the rate of profit determined on the basis of the rate of interest will not render the transaction as haram.

It is, however true that the Islamic banks and financial institutions should get rid of this practice as soon as possible, because, firstly, it takes the rate of interest as an ideal for a halal business which is not desirable, and secondly because it does not advance the basic philosophy of Islamic economy having no impact on the system of distribution. Therefore, the Islamic banks and financial institutions should strive for developing their own benchmark. This can be done by creating their own inter-bank market based on Islamic principles. The purpose can be achieved by creating a common pool which invests in asset-backed instruments like musharakah, ijarah etc. If majority of the assets of the pool is in tangible form, like leased property or equipment, shares in business concerns etc. its units can be sold and purchased on the basis of

their net asset value determined on periodical basis. These units may be negotiable and may be used for overnight financing as well. The banks having surplus liquidity can purchase these units and when they need liquidity, they can sell them. This arrangement may create inter-bank market and the value of the units may serve as an indicator for determining the profit in murabahah and leasing also

Promise to Purchase

Another important issue in murabahah financing which has been subject of debate between the contemporary Shari'ah Scholars is that the bank/financier cannot enter into an actual sale at the time when the client seeks murabahah financing from him, because the required commodity is not owned by the bank at this stage and, as explained earlier, one cannot sell a commodity not owned by him, nor can he effect a forward sale. He is, therefore, bound to purchase the commodity from the supplier, then he can sell it to the client after having its physical or constructive possession. On the other hand, if the client is not bound to purchase the commodity after the financier has purchased it from the supplier, the financier may be confronted with a situation where he has incurred huge expenses to acquire the commodity, but the client refuses to purchase it. The commodity may be of such a nature that it has no common demand in the market and is very difficult to dispose of. In this case the financier may suffer unbearable loss.

Solution to this problem is sought in the murabahah arrangement by asking the client to sign a promise to purchase the commodity when it is acquired by the financier. Instead of being a bilateral contract of forward sale, it is a unilateral promise from the client which binds himself and not the financier. Being a one-sided promise, it is distinguishable from the bilateral forward contract.

This solution is subjected to the objection that a unilateral promise creates a moral obligation but it cannot be enforced, according to Shari'ah, by the courts of law. This leads us to the question whether or not a one-sided promise is enforceable in Shari'ah. The general impression is that it is not, but before accepting this impression at its face value, we will have to examine it in the light of the original sources of Shari'ah.

A thorough study of the relevant material in the books of Islamic jurisprudence would show that the *fuqaha'* (the Muslim jurists) have different views on the subject. Their views may be summarized as follows:

1. Many of them are of the opinion that 'fulfilling a promise' is a noble quality and it is advisable for the promisor to observe it, and its violation is reproachable, but it is neither mandatory (wajib), nor enforceable through courts. This view is attributed to Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and to some Maliki jurists.[3] However as will be shown later, many Hanafi and Maliki and some Shafi'i' jurists do not subscribe to this view.

2. A number of the Muslim jurists are of the view that fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfil his promise. According to them, promise can be enforced through courts of law. This view is ascribed to Samurah ibn Jundub ﷺ the well known companion of the Holy Prophet ﷺ, Umar ibn Abd al-Aziz, Hasan al-Basri, Sa'id ibn al-Ashwa', Ishaq ibn Rahwaih and Imam al-Bukhari.[4] The same is the view of some Maliki jurists, and it is preferred by Ibn al-'Arabi and Ibn al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah.[5] The third view is presented by some Maliki jurists. They say that in normal conditions, promise is not binding, but if the promisor has caused the promise to incur some expenses or undertake some labor or liability on the basis of promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.[6]

Some contemporary scholars have claimed that the jurists who have accepted the binding nature of a promise have done so only with regard to unilateral gifts or other voluntary payments, but

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[3] See *Umdat al-Qari*, 12:121; *Mirqat al-Mafatih*, 4:653; *al-Adhkar al-Nawawi*, 282; *Fat-h al-'Ali al-Malik*, 1:254.

[4] See *Sahih al-Bukhari*, Kitab al-Shahadat, where this view is reported from the all the aforesaid jurists.

[5] Al-Qurtubi, *Al-Jami' li-Ahkam al-Qur'an*, 18:29; *Hashiyah ibn al-Shāṯ 'ala Furuq al-Qarafi*, 4:24; Al-Ghazzali, *Ihya Ulum al-Din*, 3:133; Ibn Hazm, *al-Muhalla*, 8:28.

[6] *Al-Furuq al-Qarafi*, 4:25; *Fat-h al-'Ali al-Malik*, 1:254.

none of them has accepted the binding nature of a promise to effect a bilateral commercial or monetary transaction. However, based on a close study, this notion does not seem to be correct, because the Maliki and Hanafi jurists have allowed '*Bai' bil wafa*' on the basis of binding promise. Bai' bil wafa' is a special kind of sale whereby the purchaser of an immovable property undertakes that whenever the seller will give him the price back, he will resell the house to him. The question of validity of 'Bai'bil wafa' has already been discussed in detail in the first chapter while explaining the concept of house financing on the basis of 'diminishing musharakah'. The gist of the discussion is that if repurchase by the seller is made a condition for the original sale, it is not a valid transaction, but if the parties have entered into the original sale unconditionally, but the seller has signed a separate and independent promise to repurchase the sold property, this promise will be binding on the promisor and enforceable through the courts. The binding nature of the promise in this case has been admitted by both Maliki and Hanafi jurists.[7]

Obviously, this promise does not relate to a gift. It is a promise to effect a sale in future. Still, the Maliki and Hanafi jurists have accepted it as binding on the promisor and enforceable through the courts. It is a clear proof of the fact that the jurists who hold the promises to be binding do not restrict it to the promises of gifts etc. The same principle is applicable, according to them, to the promises whereby the promisor undertakes to enter into a bilateral contract in future.

In fact, the Holy Qur'an and the Sunnah of the Holy Prophet ﷺ are very particular about fulfilling promises. The Holy Qur'an says:

وَأَوۡفُواْ بِٱلۡعَهۡدِۖ إِنَّ ٱلۡعَهۡدَ كَانَ مَسۡـُٔولٗا (بـ إسرائيل : ٣٤)

And fulfill the covenant. Surely, the covenant will be asked about (in the Hereafter) (Bani Isra'il: 34)

[7] Al-Hattab, *Tahrir al-Kalam* (Beirut, 1404 AH), 239.

يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُواْ لِمَ تَقُولُونَ مَا لَا تَفۡعَلُونَ ﴿٢﴾ كَبُرَ مَقۡتًا عِندَ ٱللَّهِ
أَن تَقُولُواْ مَا لَا تَفۡعَلُونَ ﴿٣﴾ (الصف: ٢ – ٣)

O those who believe, why do you say what you not do. It invites Allah's anger that you say what you not do. (al-Saf:2 to 3)

Imam Abu Bakr al-Jassas has said that this verse of the Holy Qur'an indicates that if one undertakes to do something, no matter whether it is a worship or a contract, it is obligatory on him to do it.[8]

The Holy Prophet ﷺ is reported to have said:

آية ا نافق ثلاث: إذا حدث كذب، وإذا وعد أخلف، وإذا او ن خان

There are three distinguishing features of a hypocrite: when he speaks, tells a lie, when he promises, he backs out and when he is given something in trust, he breaches the trust.[9]

This is only an example. There is a large number of injunctions in the ahadith of the Holy Prophet ﷺ where it is ordained to fulfil the promises and it is clearly prohibited to back out, except for a valid reason.

Therefore, it is evident from these injunctions that fulfilling promise is obligatory. However, the question whether or not a promise is enforceable in courts depends on the nature of the promise. There are certainly some sorts of promises which cannot be enforced through courts. For example, at the time of engagement the parties promise to go through the marriage. These promises create a moral obligation, but obviously they cannot be enforced through courts of law. But in commercial dealings, where a party has given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced. Therefore, on the basis of the clear injunctions of Islam, if the parties have agreed that this

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[8] Al-Jassas, *Ahkam al-Qur'an*, 3:420.

[9] *Sahih al-Bukhari*, Kitab al-Iman.

particular promise will be binding on the promisor, it will be enforceable.

This is not a question pertaining to murabahah alone. If promises are not enforceable in the commercial transactions, it may seriously jeopardize commercial activities. If somebody orders a trader to bring for him a certain commodity and promises to purchase it from him, on the basis of which the trader imports it from abroad by incurring huge expenses, how can it be allowed for the former to refuse to purchase it? There is nothing in the Holy Qur'an or Sunnah which prohibits the making of such promises enforceable.

It is on these grounds that the Islamic Fiqh Academy Jeddah has made the promises in commercial dealings binding on the promisor with the following conditions,

(a) It should be one-sided promise.
(b) The promise must have caused the promise to incur some liabilities.
(c) If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the concluded sale.
(d) If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller.[10] The actual damages will include the actual monetary loss suffered by him, but will not include the opportunity cost.

On this basis, it is allowed that the client promises to the financier that he will purchase the commodity after the latter acquires it from the supplier. This promise will be binding on him and may be enforced through courts in the manner explained above. This promise does not amount to actual sale. It will be simply a promise and the actual sale will take place after the commodity is acquired by the financier for which exchange of offer and acceptance will be necessary.

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[10] Resolution no. 2 and 3, Fifth Conference of the Islamic Fiqh Academy held in Kuwait, 1409 AH. See the academy's journal no. 5, 2:1599.

Securities against Murabahah Price

Another issue regarding murabahah financing is that the murabahah price is payable at a later date. The seller/financier naturally wants to make sure that the price will be paid at the due date. for this purpose, he may ask the client to furnish a security to his satisfaction. The security may be in the form of a mortgage or a hypothecation or some kind of lien or charge. Some basic rules about this security must, therefore, be kept in mind.

1. The security can be claimed rightfully where the transaction has created a liability or a debt. No security can be asked from a person who has not incurred a liability or debt. As explained earlier, the procedure of murabahah financing comprises of different transactions carried out at different stages. In the earlier stages of the procedure, the client does not incur a debt. It is only after the commodity is sold to him by the financier on credit that the relationship of a creditor and debtor comes into existence. Therefore, the proper way in a transaction of murabahah would be that the financier asks for a security after he has actually sold the commodity to the client and the price has become due on him, because at this stage the client incurs a debt. However, it is also permissible that the client furnishes a security at earlier stages, but after the murabahah price is determined. In this case, if the security is possessed by the financier, it will remain at his risk, meaning thereby that if it is destroyed before the actual sale to the client, he will have either to pay the market price of the mortgaged asset, and cancel the agreement of murabahah, or sell the commodity required by the client and deduct the market price of the mortgaged asset from the price of the sold property. [11]

2. It is also permissible that the sold commodity itself is given to the seller as a security. Some scholars are of the opinion that this can only be done after the purchaser has taken its delivery and not before. It means that the purchaser shall take its delivery, either physical or constructive, from the seller, then give it back to him as mortgage, so that the transaction of mortgage is distinguished from

[11] Ibn Nujaym writes,

وإ ا يصح الرهن بدين ولو موعودا . . . ولو أخذ الرهن بشرط أن يقرضه كذا ، فهلك يده قبل أن
يقرضه هلك بالأقل من قيمته و ا ى له من القرض (البحر الرائق 8:450 طبع مكة)

the transaction of sale. However, after studying the relevant material, it can be concluded that the earlier jurists have put this condition in cash sales only and not in credit sales.[12]

Therefore, it is not necessary that the purchaser takes the delivery of the sold property before he surrenders it as mortgage to the seller. The only requirement would be that the point of time whereby the property is held to be mortgaged should necessarily be specified, because from that point of time, the property will be held by the seller in a different capacity which should be clearly earmarked. For example, A sold a car to B on first of january for a price of Rs. 500,000/- to be paid on 30th June. A asked B to give a security for payment at the due date. B has not yet taken delivery of the car and he offered to A that he should keep the car as a mortgage from 2nd January. If the car is destroyed before 2nd of January the sale will be terminated and nothing will be payable by B. But if the car is destroyed after the second of January, sale is not terminated, but it will be subject to the rules prescribed for the destruction of a mortgage. According to Hanafi jurists, in this case, the seller will have to bear the loss of the car, to the extent of its market price or its agreed sale price, whichever is lesser. Therefore, if the market price of the car was 450,000/- he can claim only the remaining part of the agreed sale price (i.e. Rs. 50,000/- in the above example). If the market price of the car is Rs. 500,000/- or higher, nothing can be claimed from the purchaser.

This is the view of Hanafi School. The Shafi'i and Hanbali jurists hold that if the car is destroyed by the negligence of the mortgagee, he will have to bear the loss, according to its market price, but if the car is destroyed without any fault on his part, he will not be liable to anything, and the purchaser will bear the loss and will have to pay the full price.[13]

It is clear from the above example that the possession of A over the car as a seller carries effects and consequences different from his possession as a mortgagee and therefore it is necessary that the point of time on which the car is held by him as a mortgagee should

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[12] The detailed discussion on the subject may be found in the revised edition of my Arabic book "بحوث في قضايا فقهية معاصرة"

[13] See Ibn Qudamah, *Al-Mughni*, 4:442; al-Ghazzali, *al-Wasit*, 3:509; Ibn 'Abidin, *Radd al-Muhtar*, 5:341.

clearly be defined. Otherwise different capacities will be mixed up giving rise to dispute and rendering the security invalid.

Guaranteeing the Murabahah

The seller in a murabahah financing can also ask the purchaser/client to furnish a guarantee from a third party. In case of default in the payment of price at the due date, the seller may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him. The rules of Shari'ah regarding guarantee are fully discussed in the books of Islamic fiqh. However, I would point out to two burning issues in the context of Islamic banking.

The guarantor in the contemporary commercial atmosphere does not normally guarantee a payment without a fee charged from the original debtor. The classical Fiqh literature is almost unanimous on the point that the guarantee is a voluntary transaction and no fee can be charged on a guarantee. The most the guarantor can do is to claim his actual secretarial expenses incurred in offering the guarantee, but the guarantee itself should be free of charge. The reason for this prohibition is that the person who advances money to another person as a loan cannot charge a fee for advancing a loan, because it falls under the definition of riba or interest which is prohibited. The guarantor should be subject to this prohibition all the more, because he does not advance money. He only undertakes to pay a certain amount on behalf of the original debtor in case he defaults in payment. If the person who actually pays money cannot charge a fee, how can fee be charged by a person who has merely undertaken to pay and did not pay anything in actual terms?

Suppose, A has borrowed 100 US dollars from B who asked him to produce a guarantor. C says to A, "I pay off your debt to B right now, but you will have to pay me 110 dollars at a later date." Obviously 10 dollars charged from A are not allowed, being interest. Then D comes to A and says, "I stand as a guarantor to you, but you will have to pay me 10 dollars for this service." If we allow to charge a fee for guarantee, it will mean that C cannot charge 10 dollars, despite the fact that he has actually paid the amount, and D can charge 10 dollars, despite the fact that he has merely committed himself to pay only when A fails to pay. This

being unfair apparently, the classical Muslim jurists have forbidden the charging of a fee for guarantee, so that both C and D, in the above example, may stand on equal footing.

However, some contemporary scholars are considering the problem from a different angle. They feel that guarantee has become a necessity, especially in international trade where the sellers and the buyers do not know each other, and the payment of the price by the purchaser cannot be simultaneous with the supply of the goods. There has to be an intermediary who can guarantee the payment. It is utterly difficult to find the guarantors who can provide this service free of charge in required numbers. Keeping these realities in view, some Shari'ah scholars of our time are adopting a different approach. They say that the prohibition of guarantee fee is not based on any specific injunction of the Holy Qur'an or the Sunnah of the Holy Prophet ﷺ. It has been deduced from the prohibition of riba as one of its ancillary consequences. Moreover, guarantees in the past were of simple nature. In today's commercial activities, the guarantor sometimes needs a number of studies and a lot of secretarial work. Therefore, they opine, the prohibition of the guarantee fee should be reviewed in this perspective. The question still needs further research and should be placed before a larger forum of scholars. However, unless a definite ruling is given by such a forum, no guarantee fee should be charged or paid by an Islamic financial institution. Instead, they can charge or pay a fee to cover expenses incurred in the process of issuing a guarantee.

Penalty of Default

Another problem in murabahah financing is that if the client defaults in payment of the price at the due date, the price cannot be increased. In interest-based loans, the amount of loan keeps on increasing according to the period of default. But in murabahah financing, once the price is fixed, it cannot be increased. This restriction is sometimes exploited by dishonest clients who deliberately avoid to pay the price at its due date, because they know that they will not have to pay any additional amount on account of default.

This characteristic of murabahah should not create a big problem in a country where all the banks and financial institutions are run on Islamic principles, because the government or the central bank may develop a system where such defaultors may be penalized by depriving them from obtaining any facility from any financial institution. This system may serve a a deterrent against deliberate defaults. However, in the countries where the Islamic banks and financial institutions are working in isolation from the majority of financial institutions run on the basis of interest, this system can hardly work, because even if the client is deprived to avail of a facility from an Islamic bank, he can approach the conventional institutions.

In order to solve this problem, some contemporary scholars have suggested that the dishonest clients who default in payment deliberately should be made liable to pay compensation to the Islamic bank for the loss it may have suffered on account of default. They suggest that the amount of this compensation may be equal to the profit given by that bank to its depositors during the period of default. For example, the defaulter has paid the price three months after the due date. If the bank has given to its depositors a profit at the rate of 5%, the client has to pay 5% more as compensation for the loss of the bank. However, the scholars who allow this compensation make it subject to the following conditions:

(a) The defaulter should be given a grace period of at least one month after the maturity date during which he must be given weekly notices warning him that he should pay the price, otherwise he will have to pay compensation.

(b) It is proved beyond doubt that the client is defaulting without valid excuse. If it appears that his default is due to poverty, no compensation can be claimed from him. Indeed, he must be given respite until he is able to pay, because the Holy Qur'an has expressly said,

وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ (البقرة: ٢٨٠)

And if he (the debtor) is short of funds, then he must be given respite until he is well off. (2:280)

(c) The compensation is allowed only if the investment account of the Islamic bank has earned some profit to be distributed to the depositors. If the investment account of the bank has not earned profit during the period of default, no compensation shall be claimed from the client.

This concept of compensation, however, is not accepted by the majority of the present day scholars. (including the author). It is the considered opinion of such scholars that this suggestion neither conforms to the principles of Shari'ah nor is it able to solve the problem of default.

First of all, any additional amount charged from a debtor is riba. In the days of Jahiliyyah (before Islam) the people used to charge additional amounts from their debtors when they were not able to pay at the due date. They used to say,

إما ان تقضي وإما ان تر

Either you pay off the debt or you increase the payable amount.

The aforementioned suggestion of paying compensation to the creditor/seller resembles the same attitude.

It can be argued that the above suggestion is theoretically different from the practice of jahiliyyah in that the suggestion is to grant the debtor a grace period of one month to make sure that he is avoiding payment without a valid cause and to exempt him from compensation if it appears that his non-payment is due to poverty or a hardship. But in practical application of the concept, these conditions are hardly fulfilled, because every debtor may claim that his default is due to his financial inability at the due date, and it is very difficult for a financial institution to hold an inquiry about the financial position of each client and to verify whether or not he was able to pay. What the banks normally do is that they presume that every client was able to pay unless he has been declared as bankrupt or insolvent. It means that the concession allowed in the suggestion can be enjoyed only by the insolvent people. Obviously, insolvency is a rare phenomenon, and in this rare situation, even the interest-based banks cannot normally recover interest from the borrower. Therefore, the suggestion leaves no practical and meaningful

difference between an interest based financing and an Islamic financing.

So far as grace period is concerned, it is a minor concession which is sometimes given by the conventional banks as well. Once again, in practical terms, there is no material difference between interest and the late payment charged as compensation.

It is argued in favor of charging compensation that the Holy Prophet ﷺ has condemned the person who delays the payment of his dues without a valid cause. According to the well-known hadith he has said,

لَيّ الواجد يحِل عقوبته وعرضه

> The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace.[14]

The argument runs that the Holy Prophet ﷺ has permitted to inflict a punishment on such a person. The punishments may be of different kinds, including the imposition of a monetary penalty. But this argument overlooks the fact that even if it is assumed that imposing fine or a monetary penalty is allowed in Shari'ah,[15] it is imposed by a court of law and is normally paid to the government. Nobody has allowed a situation where an aggrieved party imposes the fine on its own (and for its own benefit) without a judgment of a court, competent to decide the matter.

Moreover, had it been a recognized punishment, it should have been imposed even if the investment account has earned no profit during that period, because the guilt of the defaulter is established and it has no nexus with the profit of the investment account of the bank.

In fact, the suggestion of compensation equal to the rate of profit of the investment account is based on the concept of opportunity cost of money. This concept is foreign to the principles of Shari'ah. Islam does not recognize opportunity cost of money,

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[14] *Sahih al-Bukhari*, hadith no. 2400, with *Fath al-Bari*, 5:62.

[15] Many classical jurists do not allow the imposition of fine (تعزير بالمال) even by a court of law; however, some classical jurists, like Imam Ahmad and Abu Yusuf allow it and this is the preferred view according to most contemporary jurists.

because after the elimination of interest from the economy, money has no definite return. It is always exposed to loss as well as it has the ability to earn a profit. And it is the risk of loss which makes it entitled to gain a return.

Another point is worth attention. The one who defaults in payment of debt is, at the most, like a thief or a usurper. But the study of the rules prescribed for theft and usurpation would show that a thief has been subjected to very severe punishment of amputating his hands, but he was never asked to pay an additional mount to compensate the victim of theft. Similarly, if a person has usurped the money of another person, he may be punished by way of *ta'zir*, but no Muslim jurist has ever imposed on him a financial penalty to compensate the owner.

Imam al-Shafi'i is of the view that if someone usurps the land of another person, he will have to pay the rent of the land according to the market rate. But if he has usurped money, he will return the equal amount of money and not more.[16]

All these rules go a long way to prove that the opportunity cost of money is never recognized by the Islamic Shari'ah, because, as explained above, money has no definite return, nor any intrinsic utility.

On the basis of what is stated above, the idea of compensation to be charged from a defaulter is not approved by most of the contemporary scholars. The question was thoroughly discussed in the annual session of Islamic Fiqh Academy, Jeddah, and it was resolved that no such compensation is allowed in Shari'ah.[17]

All this discussion relates to the impermissibility of the proposed compensation in Shari'ah. Now it is to be noted that this proposal does not solve the problem of default at all. To the contrary, it may encourage the debtors to commit as much default as they wish. The reason is that, according to this suggestion, the defaulter is asked to pay compensation equal to the return earned by the depositors during the period of default. It is evident that the rate of return earned by the depositors is always less than the rate of profit paid by the customer in a murabahah transaction. Therefore, the customer

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[16] Al-Shirazi, *al-Muhadh-dhab*, 1:370.

[17] Resolution no. 53, Vth Annual Session of the Islamic Fiqh Academy, Jeddah, Journal no. 6, 1:447.

will be paying after default, much less than he was paying before the default. Therefore, he would willingly accept to pay this amount and not pay the amount of price which he will invest in a more profitable activity. Suppose the rate of profit agreed in a murabahah transaction of six moths is 15% p.a. and the rate of profit declared to the depositors is 10%. p.a. It means that if the client withholds the price of murabahah after its maturity date and keeps it for another six months, he will have to pay the compensation at the rate of 10% p.a. which is much less than the rate of original murabahah (i.e. 15%). As such he will default and enjoy another facility for the next six months at a lesser rate.

This proposal, therefore, is not only against Shari'ah, but also deficient in meeting the problem of default.

The Alternative Suggestion

The question now arises as to how the banks and financial institutions may solve this problem. If nothing is charged from the defaulters, it may be a greater incentive for a dishonest person to default continuously. Here is the answer to this question:

We have already mentioned that the real solution to this problem is to develop a system where the defaulters are duly punished by depriving them from enjoying a financial facility in future. However, as commented earlier, this may be only where the whole banking system is based on Islamic principles, or the Islamic banks are given due protection against defaulters. Therefore, up to a time when this goal is reached, we may need some other alternative.

For this purpose it was suggested that the client, when entering into a murabahah transaction, should undertake that in case he defaults in payment at the due date, he will pay a specified amount to a charitable fund maintained by the bank. It must be ensured that no part of this amount shall form part of the income of the bank. However, the bank may establish a charitable fund for this purpose and all amounts credited therein shall be exclusively used for purely charitable purpose approved by the Shari'ah. The bank may also advance interest-free loans to the needy persons from this charitable fund.

This proposal is based on a ruling given by some Maliki jurists who say that if a debtor is asked to pay an additional amount in case

of default, it is not allowed by Shari'ah, because it amounts to charging interest. However, in order to assure the creditor of prompt payment, the debtor may undertake to give some amount in charity in case of default. This is, in fact, a sort of Yamin (vow) which is a self-imposed penalty to keep oneself away from default. Normally, such 'vows' create a moral or religious obligation and are not enforceable through courts. However, some Maliki jurists allow to make it justiceable,[18] and there is nothing in the Holy Qur'an or in the Sunnah of the Holy Prophet ﷺ which forbids making this 'vow' enforceable through the courts of law. Therefore, in cases of genuine need, this view can be acted upon. But, while implementing this proposal, the following points must be kept in mind.

1. The proposal is meant only to pressurize the debtors on paying their dues promptly and not to increase the income of the creditor / financier, nor to compensate him for his opportunity cost. Therefore, it must be ensured that no part of the penalty forms part of the income of the bank in any case, nor can it be used to pay taxes or to set-off any liability of the financier.

2. Since the amount of penalty is not deserved by the financier as his income, but it goes to charity, it may be any amount willfully undertaken by the debtor. It can also be determined on per cent per annum basis. Therefore, it may serve as a real deterrent against deliberate default, unlike the former suggestion of compensation which, as explained earlier, may tend to encourage the defaults.

3. Since the penalty undertaken by the client is originally a self-undertaken vow, and not penalty charged by the financier, the agreement should reflect this concept. Therefore, the proper wording of the penalty clause would be on the following pattern,

> The client hereby undertakes that if he defaults in payment of any of his dues under this agreement, he shall pay to the charitable account/fund maintained by the Bank/Financier a sum calculated on the basis of ...% per annum for each day of default unless he establishes through the evidence satisfactory to the Bank/financier that his non-payment at the due date was caused due to poverty or some other factors beyond his control.

[18] Al-Hattab, *Tahrir al-Kalam* (Beirut, 1404 AH), 176.

4. Being a vow of charitable act, it was originally permissible for the client to give the stipulated amount to any charity of his own choice, but in order to ensure that he will pay, the charitable account or fund maintained by the financier/bank is specified in the proposed undertaking. This specific undertaking does not violate any principle of Shari'ah. However, it is necessary that the bank or the financial institution maintains a separate fund, or at least, a separate account for this purpose and the amounts credited to that account must be spent in well-defined charities known to the client/debtor.

This proposal has now been implemented successfully in a large number of Islamic financial institutions.

No Roll Over in Murabahah

Another rule which must be remembered and fully complied with is that murabahah transaction cannot be rolled over for a further period. In an interest-based financing, if a customer of the bank cannot pay at the due date for any reason, he may request the bank to extend the facility for another term. If the bank agrees, the facility is rolled over on the terms and conditions mutually agreed at that point of time, whereby the newly agreed rate of interest is applied to the new term. It actually means that another loan of the same amount is re-advanced to the borrower.

Some Islamic banks or financial institutions, who misunderstood the concept of murabahah and took it as merely a mode of financing analogous to an interest-based loan, started using the concept of roll-over to murabahah also. If the client requests them to extend the maturity date of murabahah, they roll it over and extend the period of payment on an additional mark-up charged from the client which practically means that another separate murabahah is booked on the same commodity. This practice is totally against the well-settled principles of Shari'ah.

It should be clearly understood that murabahah is not a loan. It is the sale of a commodity the price of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client. It is no more a property of the seller. What the seller can legitimately claim is the agreed price which has become a debt

payable by the buyer. Therefore, there is no question of effecting another sale on the same commodity between the same parties. The roll-over in murabahah is nothing but interest pure and simple because it is an agreement to charge an additional amount on the debt created by the murabahah sale.

Rebate on Earlier Payment

Sometimes the debtor wants to pay earlier than the specified date. In this case he wants to earn a discount on the agreed deferred price. Is it permissible to allow him a rebate for his earlier payment? This question has been discussed by the classical jurists in detail. The issue is known in the Islamic legal literature as "ضع وتعجل" (Give discount and receive soon). Some earlier jurists have held this arrangement as permissible, but the majority of the Muslim jurists, including the four recognized schools of Islamic jurisprudence do not allow it, if the discount is held to be a condition for earlier payment.[19]

The view of those who allow this arrangement is based on a hadith in which Abdullah ibn Abbas ؓ is reported to have said that when the Jews belonging to the tribe of Banu Nadir were banished from Madinah (because of their conspiracies) some people came to the Holy Prophet ﷺ and said, "You have ordered them to be expelled, but some people owe them some debts which have not yet matured." Thereupon the Holy Prophet ﷺ said to them (i.e., the Jews who were the creditors)

ضعوا وتعجلوا

Give discount and receive (your debts) soon.[20]

The majority of the Muslim jurists, however, does not accept this hadith as authentic. Even Imam al-Baihaqi, who has reported this hadith in his book, has expressly admitted that this is a weak narration.

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[19] Ibn Qudamah, *Al-Mughni*, 4:174–75. For a full discussion, see my Arabic book *Bahuth fi Qadaya Fiqhiyyah Mu'asirah* (وث قضايا فقهية معاصرة), 25.

[20] Al-Bayhaqi, al-Sunan al-Kubra, 6:28.

Even if the hadith is held to be authentic, the exile of Banu Nadir was in the second year after hijrah, when riba was not yet prohibited.

Moreover, al-Waqidi has mentioned that Banu Nadir used to advance usurious loans. Therefore, the arrangement allowed by the Holy Prophet ﷺ was that the creditors forego the interest and the debtors pay the principal sooner. Al-Waqidi has narrated that Sallam ibn Abi Huqaiq, a Jew of Banu Nadir, had advanced eighty dinars to Usaid ibn Hudayr رضي الله عنه payable after one year with an addition of 40 dinars. Thus, Usaid رضي الله عنه owed him 120 dinars after one year. After this arrangement, he paid the principal amount of 80 dinars and Sallam withdrew from the rest.[21]

For these reasons, the majority of the jurists hold that if the earlier payment is conditioned with discount, it is not permissible. However, if this is not taken to be a condition for earlier payment, and the creditor gives a rebate voluntarily on his own, it is permissible.

The same view is taken by the Islamic Fiqh Academy in its annual session.[22]

It means that in a murabahah transaction effected by an Islamic bank or financial institution, no such rebate can be stipulated in the agreement, nor can the client claim it as his right. However, if the bank or a financial institution gives him a rebate on its own, it is not objectionable, especially where the client is a needy person. For example, if a poor farmer has purchased a tractor or agricultural inputs on the basis of murabahah, the bank should give him a voluntary discount.

Calculation of Cost in Murabahah

It is already mentioned that the transaction of murabahah contemplates the concept of cost-plus sale, therefore, it can be effected only where the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained, no murabahah can be possible. In this

[21] Al-Waqidi, *al-Maghazi*, 1:374.

[22] Resolution no. 66, VIth Session of Islamic Fiqh Academy, Jeddah, Journal no. 7, 2:217.

case, the sale must be effected on the basis of musawamah (i.e. sale without reference to cost).

This principle leads to another rule: the murabahah transaction should be based on the same currency in which the seller has purchased the commodity from the original supplier. If the seller has purchased it for Pakistani rupees, the onward sale to the ultimate purchaser should also be based on Pakistani rupees, and if the first purchase has occurred in U.S. dollars, the price of murabahah should be based on dollars as well, so that the exact cost may be ascertained.

However, in the case of international trade, it may be difficult to base both purchases on the same currency. If the commodity intended to be sold to the customer is imported from a foreign country, while the ultimate purchaser is in Pakistan, the price of the original sale has to be paid in a foreign currency and the price of the second sale will be determined in Pak. Rupees.

This situation may be met with in two ways. Firstly, if the ultimate purchaser agrees and the laws of the country allow, the price of the second sale may also be determined in dollars.

Secondly, if the seller has purchased the commodity by converting Pakistani Rupees into dollars, the exact amount of Pak rupees paid by the seller to convert them into dollars can be taken as the cost price and the profit of murabahah can be added thereon.

In some cases, the bank purchases the commodity from abroad at a price payable after three months or in different installments, and sells the commodity to his client before he pays the full price to the supplier. Since he pays the price in dollars, its equivalent in Pakistani Rupees are not known at the time when the commodity is sold to the client. Due to fluctuation in the price of dollars in Pak Rupees, the bank may have to pay more than it anticipated at the time of murabahah sale. For example, the rate of U.S. dollars at the time of murabahah was Rs. 40/- for one dollar. The price of murabahah was settled according to this rate, but when the bank paid the price to the supplier, the dollar rate increased to Rs. 41/- for one dollar, meaning thereby that the cost of the bank increased by 2.5%. In order to meet this situation, some financial institutions put a condition in the murabahah agreement that in case of such fluctuation in currency rates, the client shall bear the additional cost. According to the classical Muslim jurists, murabahah based on

this condition is not valid because it leads to uncertainty of the price at the time of sale. Such uncertainty continues upto a date after three months when the buyer actually pays the price to the supplier. Such uncertainty renders the transaction invalid. Therefore, there are following options open to the bank in this issue:

(a) The bank should purchase that commodity on the basis of L/C at sight and should pay the price to the supplier before effecting sale with the customer. In this case no question of fluctuation in currency rates will be involved. The murabahah price can be determined on the basis of the market rate of dollars on the date when the bank has paid the price to the supplier.

(b) The bank determines the murabahah price in US dollars rather than in Pak rupees, so that the deferred murabahah price is paid by the customer in dollars. In this case the bank will be entitled to receive dollars from the customer and the risk of the fluctuation in dollar's price will be borne by the purchaser.

(c) Instead of murabahah, the deal may be on the basis of musawamah (a sale without reference to the cost of the seller) and the price may be fixed as to cover the anticipated fluctuation in the currency rates.

Subject Matter of Murabahah

All commodities which may be subject matter of sale with profit can be subject matter of murabahah, because it is a particular kind of sale. Therefore, the shares of a lawful company may be sold or purchased on murabahah basis, because according to the Islamic principles, the shares of a company represent the holder's proportionate ownership in the assets of the company. If the assets of a company can be sold with profit, its shares can also be sold by way of murabahah. But it goes without saying that the transaction must fulfil all the basic conditions, already discussed, for the validity of a murabahah transaction. Therefore, the seller must first acquire the possession of the shares with all their rights and obligations, then sell them to his client. A buy back arrangement or selling the shares without taking their possession is not allowed at all.

Conversely, no murabahah can be effected on things which cannot be subject - matter of sale, For example murabahah is not possible in exchange of currencies, because it must be spontaneous

or, if deferred, on the market rate prevalent on the date of the transaction.[23] Similarly, the commercial papers representing a debt receivable by the holder cannot be sold or purchased except at par value, and therefore no murabahah can be effected in respect of such papers. Similarly, any paper entitling the holder to receive a specified amount of money from the issuer cannot be negotiated. The only way of its sale is to transfer if for its face value. Therefore, they cannot be sold on murabahah basis.

Rescheduling of Payments in Murabahah

If the purchaser/client in murabahah financing is not able to pay according to the dates agreed upon in the murabahah agreement, he sometimes requests the seller / the bank for rescheduling the installments. In conventional banks, the loans are normally rescheduled on the basis of additional interest. This is not possible in murabahah payments. If the installments are rescheduled, no additional amount can be charged for rescheduling. The amount of the murabahah price will remain the same in the same currency.

Some Islamic banks proposed to reschedule the murabahah price in a hard currency different from the one in which the original sale took place. This was proposed to compensate the bank through appreciation of the value of the hard currency. Since this benefit was proposed to be drawn from rescheduling, it is not permissible. Rescheduling must always be on the basis of the same amount in the same currency. At the time of payment however, the purchaser may pay with the consent of the seller, in a different currency on the basis of the exchange rate of that day (i.e. the day of payment) and not the rate of the date of transaction.

Securitization of Murabahah

Murabahah is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is obvious. If the purchaser/client in a murabahah transaction signs a paper to evidence his indebtedness towards the seller/financier, the paper will represent a monetary

[23] For detailed discussion on the subject, see my Arabic treatise *Ahkam al-Awraq al-Naqdiyyah* (أحكام الأوراق النقدية).

debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore, the paper representing a monetary obligation arising out of a murabahah transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like musharakah, leasing and murabahah, then this portfolio may issue negotiable certificates subject to certain conditions more fully discussed in the chapter of "Islamic Funds".

Some Basic Mistakes in Murabahah Financing

After explaining the concept of murabahah and its relevant issues, it will be pertinent to highlight some basic mistakes often committed by the financial institutions in the practical implementation of the concept.

1. The first and the most glaring mistake is to assume that murabahah is a universal instrument which can be used for every type of financing offered by conventional interest-based banks and NBFIs.[24] Under this false assumption, some financial institutions are found using murabahah for financing overhead expenses of a firm or company like paying salaries of their staff, paying the bills of electricity etc. and setting off their debts payable to other parties. This practice is totally unacceptable, because murabahah can be used only where a commodity is intended to be purchased by the customer. If funds are required for some other purpose, murabahah cannot work. In such cases, some other suitable modes of financing, like musharakah, leasing etc. can be used according to the nature of the requirement.

2. In some cases, the clients sign the murabahah documents merely to obtain funds. They never intend to employ these funds to purchase a specific commodity. They just want funds for unspecified purpose, but to satisfy the requirement of the formal

[24] NBFI: Non-Bank Financial Institution.

documents, they name a fictitiously commodity. After receiving money, they use it for whatever purpose they wish.

Obviously this is a fictitious deal, and the Islamic financiers must be very careful about it. It is their duty to make sure that the client really intends to purchase a commodity which may be subject to murabahah. This assurance must be obtained by the authorities sanctioning the facility to the customer. Then, all necessary steps must be taken to confirm that the transaction is genuine. For example:

(a) Instead of giving funds to the customer, the purchase price should be paid directly to the supplier.

(b) If it becomes necessary that the client is entrusted with funds to purchase the commodity on behalf of the financier, his purchase should be evidenced by invoices or similar other documents which he should present to the financier.

(c) Where either one of the above two requirements is not possible to be fulfilled, the financing institution should arrange for physical inspection of the purchased commodities.

Anyhow, the Islamic financial institutions are under an obligation to make sure that murabahah is a real and genuine transaction of actual sale and is not being misused to camouflage an interest-based loan.

3. In some cases, sale of commodity to the client is effected before the commodity is acquired from the supplier. This mistake is invariably committed in transactions where all the documents of murabahah are signed at one time without taking into account various stages of the murabahah. Some institutions have only one murabahah agreement which is signed at the time of disbursement of money, or in some cases, at the time of approving the facility. This is totally against the basic principles of murabahah. It has already been explained in this article that the murabahah arrangement practiced by the banks is a package of different contracts which come into play one after another at their respective stages. These stages have been fully highlighted earlier while discussing the concept of murabahah financing. Without observing this basic feature of murabahah financing, the whole transaction turns into an interest-bearing loan. Merely changing the nomenclature does not make it lawful in the eyes of Shari‘ah.

The representatives of the Shari‘ah Boards of the Islamic banks, when they check the transactions of the bank with regard to their compliance with Shari‘ah, must make sure that all these stages have been really observed, and every transaction is effected at its due time.

4. International commodity transactions are often resorted to for liquidity management. Some Islamic banks feel that these transactions, being asset-based, can easily be entered into on murabahah basis, and they enter the field ignoring the fact that the commodity operations as in vogue in the international markets, do not conform to the principles of Shari‘ah. In many cases, they are fictitious transactions where no delivery takes place. The parties end up paying differences. In some cases, there are real commodities but they are subjected to forward sales or short sales which are not allowed in Shari‘ah. Even if the transactions are restricted to spot sales, they should be formulated on the basis of Islamic principles of murabahah by fulfilling all the necessary conditions already mentioned in this book.

5. It is observed in some financial institutions that they effect murabahah on commodities already purchased by their clients from a third party. This is again a practice never warranted by the Shari‘ah. Once the commodity is purchased by the client himself, it cannot be purchased again from the same supplier. If it is purchased by the bank from the client himself and is sold to him, it is a buy-back technique which is not allowed in Shari‘ah, especially in murabahah. In fact, if the client has already purchased a commodity, and he approaches the bank for funds, he either wants to set-off his liability towards his supplier, or he wants to use the funds for some other purpose. In both cases an Islamic bank cannot finance him on the basis of murabahah. Murabahah can be effected only on commodities not yet purchased by the client.

Conclusions

From the foregoing discussion on different aspects of murabahah financing, the following conclusions may be summarized as the basic points to remember:

1. Murabahah is not a mode of financing in its origin. It is a simple sale on cost-plus basis. However, after adding the concept of

deferred payment, it has been devised to be used as a mode of financing only in cases where the client intends to purchase a commodity. Therefore, it should neither be taken as an ideal Islamic mode of financing, nor a universal instrument for all sorts of financing. It should be taken as a transitory step towards the ideal Islamic system of financing based on musharakah or mudarabah. Otherwise its use should be restricted to areas where musharakah or mudarabah cannot work.

2. While approving a murabahah facility, the sanctioning authority must make sure that the client really intends to purchase commodities which may be subject-matter of murabahah. It should never be taken as merely a paper-work having no genuine basis.

3. No murabahah can be effected for overhead expenses, paying the bills or settling the debts of the client, nor can it be effected for purchase of currencies.

4. It is the foremost condition for the validity of murabahah that the commodity comes in the ownership and physical or constructive possession of the financier before he sells it to the customer on murabahah basis. There should be a time in which the risk of the commodity is borne by the financier. Without having its ownership or assuming the risk of the commodity, though for a short while, the transaction is not acceptable to Shari‘ah and the profit accruing therefrom is not halal.

5. The best way to effect murabahah is that the financier himself purchases the commodity directly from the supplier and after taking its delivery sells it to the client on murabahah basis. Making the client agent to purchase on behalf of the financier renders the arrangement dubious. For this very reason some Shari‘ah Boards have forbidden this technique, except in cases where direct purchase is not possible at all. Therefore, the agency concept should be avoided as far as possible.

6. If in cases of genuine need, the financier appoints the client his agent to purchase the commodity on his behalf, his different capacities (i.e. as agent and as ultimate purchaser) should be clearly distinguished. As an agent, he is a trustee, and unless he commits negligence or fraud, he is not liable to any loss so far as the commodity is in his possession as agent of the financier. After he purchases the commodity in his capacity as agent, he must inform the financier that, in fulfilling his obligation as his agent, he has

taken delivery of the purchased commodity and now he extends his offer to purchase it from him. When, in response to this offer, the financier conveys his acceptance to this offer, the sale will be deemed to be complete, and the risk of the property will be passed on to the client as purchaser. At this point, he will become a debtor and the consequences of indebtedness will follow. These are the necessary requirements of murabahah financing which can never be dispensed with. While describing the concept of "murabahah as a mode of financing" we have already identified five stages of murabahah under agency agreement. Each and every step out of these five is necessary in its own right and neglecting any one of them renders the whole arrangement unacceptable.

It should be noted with care that murabahah is a border-line transaction and a slight departure from the prescribed procedure makes it step in the prohibited area of interest-based financing. Therefore this transaction must be carried out with due diligence and no requirement of Shari'ah should be taken lightly.

7. Two different prices for cash and credit sales are allowed on condition that either of the two options is specifically elected by the customer. Once the price is fixed, it can neither be increased because of late payment, nor decreased on earlier payment.

8. In order to assure that the purchaser will pay the price promptly, he may undertake that in case of default, he will pay a certain amount to the charitable fund maintained by the financing institution. This amount may be based on per cent per annum concept, but it must invariably be spent for purely charitable purposes and should in no case form part of the income of the institution.

9. In case of earlier payment, no rebate can be claimed by the client. However, the institution may at it own option, forego some part of the price without making it a pre-condition in the agreement.

6

Ijarah

"*Ijarah*" is a term of Islamic fiqh. Lexically, it means 'to give something on rent'. In the Islamic jurisprudence, the term '*ijarah*' is used for two different situations. In the first place, it means 'to employ the services of a person on wages given to him as a consideration for his hired services.' The employer is called *musta'jir* while the employee is called *ajir*.

Therefore, if A has employed B in his office as a manager or as a clerk on a monthly salary, A is musta'jir, and B is an ajir. Similarly, if A has hired the services of a porter to carry his baggage to the airport, A is a musta'jir while the porter is an ajir, and in both cases the transaction between the parties is termed as ijarah. This type of ijarah includes every transaction where the services of a person are hired by someone else. He may be a doctor, a lawyer, a teacher, a laborer or any other person who can render some valuable services. Each one of them may be called an 'ajir' according to the terminology of Islamic law, and the person who hires their services is called a 'musta'jir', while the wages paid to the ajir are called their 'ujrah'.

The second type of ijarah relates to the usufructs of assets and properties, and not to the services of human beings. 'Ijarah' in this sense means 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.' In this case, the term 'ijarah' is analogous to the English term 'leasing'. Here the lessor is called '*mu'jir*', the lessee is called '*musta'jir*' and the rent payable to the lessor is called '*ujrah*'.

Both these kinds of 'ijarah' are thoroughly discussed in the literature of Islamic jurisprudence and each one of them has its own

set of rules. But for the purpose of the present book, the second type of ijarah is more relevant, because it is generally used as a form of investment, and as a mode of financing also.

The rules of ijarah, in the sense of leasing, is very much analogous to the rules of sale, because in both cases something is transferred to another person for a valuable consideration. The only difference between ijarah and sale is that in the latter case the corpus of the property is transferred to the purchaser, while in the case of ijarah, the corpus of the property remains in the ownership of the transferor, but only its usufruct i.e. the right to use it, is transferred to the lessee.

Therefore, it can easily be seen that 'ijarah' is not a mode of financing in its origin. It is a normal business activity like sale. However, due to certain reasons, and in particular, due to some tax concessions it may carry, this transaction is being used in the Western countries for the purpose of financing also. Instead of giving a simple interest - bearing loan, some financial institutions started leasing some equipment's to their customers. While fixing the rent of these equipment, they calculate the total cost they have incurred in the purchase of these assets and add the stipulated interest they could have claimed on such an amount during the lease period. The aggregate amount so calculated is divided on the total months of the lease period, and the monthly rent is fixed on that basis.

The question whether or not the transaction of leasing can be used as a mode of financing in Shari'ah depends on the terms and conditions of the contract. As mentioned earlier, leasing is a normal business transaction and not a mode of financing. Therefore, the lease transaction is always governed by the rules of Shari'ah prescribed for ijarah. Let us, therefore, discuss the basic rules governing the lease transactions, as enumerated in the Islamic Fiqh. After the study of these rules, we will be able to understand under what conditions the ijarah may be used for the purpose of financing.

Although the principles of ijarah are so numerous that a separate volume is required for their full discussion, we will attempt in this chapter to summarize those basic principles only which are necessary for the proper understanding of the nature of the transaction and are generally needed in the context of modern

economic practice. These principles are recorded here in the form of brief notes, so that the readers may use them for quick reference.

Basic Rules of Leasing

1. Leasing is a contract whereby the owner of something transfers its usufruct to another person for an agreed period, at an agreed consideration.

2. The subject of lease must have a valuable use. Therefore, things having no usufruct at all cannot be leased.

3. It is necessary for a valid contract of lease that the corpus of the leased property remains in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything which cannot be used without consuming cannot be leased out. Therefore, the lease cannot be effected in respect of money, eatables, fuel and ammunition etc. because their use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charged on this invalid lease shall be an interest charged on a loan.

4. As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property shall be borne by the lessee.

Example:

A has leased his house to B. The taxes referable to the property shall be borne by A, while the water tax, electricity bills and all expenses referable to the use of the house shall be borne by B, the lessee.

5. The period of lease must be determined in clear terms.

6. The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. If no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course. However if he wishes to use it for an abnormal purpose, he cannot do so unless the lessor allows him in express terms.

7. The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence on the part of the lessee.

8. The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

9. A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.

10. A joint owner of a property can lease his proportionate share to his co-sharer only, and not to any other person.[1]

11. It is necessary for a valid lease that the leased asset is fully identified by the parties.

Example:
A said to B. "I lease you one of my two shops." B agreed. The lease is void, unless the leased shop is clearly determined and identified.

12. The rental must be determined at the time of contract for the whole period of lease.

It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of effecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.

Example (1): A leases his house to B for a total period of 5 years. The rent for the first year is fixed as Rs. 2000/- per month and it is agreed that the rent of every subsequent year shall be 10% more than the previous one. The lease is valid.

Example (2): In the above example, A puts a condition in the agreement that the rent of Rs. 2000/- per month is fixed for the

[1] See Ibn 'Abidin, *Radd al-Muhtar*, 6:47–48.

first year only. The rent for the subsequent years shall be fixed each year at the option of the lessor. The lease is void, because the rent is uncertain.

The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of Shari'ah, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the Shari'ah are fully adhered to.

14. The lessor cannot increase the rent unilaterally, and any agreement to to this effect is void.

15. The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.

16. The lease period shall commence from the date on which the leased asset has been delivered to the lessee, no matter whether the lessee has started using it or not.

17. If the leased asset has totally lost the function for which it was leased, and no repair is possible, the lease shall terminate on the day on which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset as, it was immediately before the loss.

Lease as a Mode of Financing

Like murabahah, lease is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest. This kind of lease is generally known as the 'financial lease' as distinguished from the 'operating lease' and many basic features of actual leasing transaction have been dispensed with therein.

When interest-free financial institutions were established in the near past, they found that leasing is a recognized mode of finance

throughout the world. On the other hand, they realized that leasing is a lawful transaction according to Shari'ah and it can be used as an interest-free mode of financing. Therefore, leasing has been adopted by the Islamic financial institutions, but very few of them paid attention to the fact that the 'financial lease' has a number of characteristics more similar to interest than to the actual lease transaction. That is why they started using the same model agreements of leasing as were in vogue among the conventional financial institutions without any modification, while a number of their provisions were not in conformity with Shari'ah.

As mentioned earlier, leasing is not a mode of financing in its origin. However, the transaction may be used for financing, subject to certain conditions. It is not sufficient for this purpose to substitute the name of 'interest' by the name of 'rent' and replace the name of 'mortgage' by the name of 'leased asset'. There must be a substantial difference between leasing and an interest-bearing loan. That will be possible only by following all the Islamic rules of leasing, some of which have been mentioned in the first part of this chapter.

To be more specific, some basic differences between the contemporary financial leasing and the actual leasing allowed by the Shari'ah are indicated below.

1. The Commencement of Lease

Unlike the contract of sale, the agreement of ijarah can be effected for a future date.[2] Thus, while a forward sale is not allowed in Shari'ah, an 'ijarah' for a future date is allowed, on the condition that the rent will be payable only after the leased asset is delivered to the lessee.

In most cases of the 'financial lease' the lessor i.e. the financial institution purchases the asset through the lessee himself. The lessee purchases the asset on behalf of the lessor who pays its price to the supplier, either directly or through the lessee. In some lease agreements, the lease commences on the very day on which the price is paid by the lessor, irrespective of whether the lessee has effected payment to the supplier and taken delivery of the asset or

[2] See Ibn 'Abidin, *Radd al-Muhtar*, 4:64.

not. It may mean that lessee's liability for the rent starts before the lessee takes delivery of the asset. This is not allowed in Shari'ah, because it amounts to charging rent on the money given to the customer which is nothing but interest, pure and simple.

The correct way, according to Shari'ah, is that the rent be charged after the lessee has taken delivery of the asset, and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay.

2. Different Relations of the Parties

It should be clearly understood that when the lessee himself has been entrusted with the purchase of the asset intended to be leased, there are two separate relations between the institution and the client which come into operation one after the other. In the first instance, the client is an agent of the institution to purchase the asset on latter's behalf. At this stage, the relation between the parties is nothing more than the relation of a principal and his agent. The relation of lessor and lessee has not yet come into operation.

The second stage begins from the date when the client takes delivery from the supplier. At this stage, the relation of lessor and lessee comes to play its role. These two capacities of the parties should not be mixed up or confused with each other. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period, he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

However, there is a point of difference between murabahah and leasing. In murabahah, as mentioned earlier, actual sale should take place after the client takes delivery from the supplier, and the previous agreement of murabahah is not enough for effecting the actual sale. Therefore, after taking possession of the asset as an agent, he is bound to give intimation to the institution, and make an offer for the purchase from him. The sale takes place after the institution accepts the offer.

The procedure in leasing is different, and a little shorter. Here the parties need not effect the lease contract after taking delivery. If the institution, while appointing the client its agent, has agreed to

lease the asset with effect from the date of delivery, the lease will automatically start on that date without any additional procedure. There are two reasons for this difference between murabahah and leasing:

Firstly, it is a necessary condition for a valid sale that it should be effected instantly. Thus, a sale attributed to a future date is invalid in Shari'ah. But leasing can be attributed to a future date. Therefore, the previous agreement is not sufficient in the case of murabahah, while it is quite enough in the case of leasing.

Secondly, the basic principle of Shari'ah is that one cannot claim a profit or a fee for a property the risk of which was never borne by him. Applying this principle to murabahah, the seller cannot claim a profit over a property which never remained under his risk for a moment. Therefore, if the previous agreement is held to be sufficient for effecting a sale between the client and the institution, the asset shall be transferred to the client simultaneously when he takes its possession, and the asset shall not come into the risk of the seller even for a moment. That is why the simultaneous transfer is not possible in murabahah, and there should be a fresh offer and acceptance after the delivery.

In leasing, however, the asset remains under the risk and ownership of the lessor throughout the leasing period, because the ownership has not been transferred. Therefore, if the lease period begins right from the time when the client has taken delivery, it does not violate the principle mentioned above.

3. Expenses Consequent to Ownership

As the lessor is the owner of the asset, and he has purchased it from the supplier through his agent, he is liable to pay all the expenses incurred in the process of its purchase and its import to the country of the lessor. Consequently, he is liable to pay the freight and the customs duty etc. He can, of course, include all these expenses in his cost and can take them into consideration while fixing the rentals, but as a matter of principle, he is liable to bear all these expenses as the owner of the asset. Any agreement to the contrary, as is found in the traditional financial leases, is not in conformity with Shari'ah.

4. Liability of the Parties in Case of Loss to the Asset

As mentioned in the basic principles of leasing, the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear which normally occurs during its use. But he cannot be made liable to a loss caused by the factors beyond his control. The agreements of the traditional 'financial lease' generally do not differentiate between the two situations. In a lease based on the Islamic principles, both the situations should be dealt with separately.

5. Variable Rentals in Long Term Leases

In the long term lease agreements it is mostly not in the benefit of the lessor to fix one amount of rent for the whole period of lease, because the market conditions change from time to time.

In this case the lessor has two options:

(a) He can contract lease with a condition that the rent shall be increased according to a specified proportion (e.g. 5%) after a specified period (like one year).

(b) He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent, with full liberty to each one of them to refuse the renewal, in which case the lessee is bound to vacate the leased property and return it back to the lessor.

These two options are available to the lessor according to the classical rules of Islamic Fiqh. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark which is so well-known and well-defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5% in the rate of inflation, it will result in an increase of 5% in the rent as well. Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit

through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period. Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent.

This arrangement has been criticized on two grounds:

The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of murabahah, the rate of interest is used as a benchmark only. So far as other requirements of Shari'ah for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest - based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset looses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorised as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

It is thus clear that the use of the rate of interest merely as a benchmark does not render the contract invalid as an interest - based transaction. It is, however, advisable at all times to avoid using interest even as a benchmark, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance of interest whatsoever.

The second objection to this arrangement is that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply *jahalah* and *gharar* which is not permissible in Shari'ah. It is one of the basic requirements of Shari'ah that the consideration in every contract must be known to the parties when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest, which is unknown, the amount of rent will remain unknown as well. This is the jahalah or gharar which renders the transaction invalid.

Responding to this objection, one may say that the jahalah has been prohibited for two reasons: One reason is that it may lead to dispute between the parties. This reason is not applicable here, because both parties have agreed with mutual consent upon a well defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined, based on this benchmark, will be acceptable to both parties. Therefore, there is no question of any dispute between them.

The second reason for the prohibition of jahalah is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example, it may be provided in the base contract that the rental amount after a given period, will be changed according to the change in the rate of interest, but it will in no case be higher than 15% or lower than 5% of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15% the rent will be increased only up to 15%. Conversely, if the decrease in the rate of interest is more than 5% the rent will not be decreased to more than 5%. In our opinion, this is the moderate view which takes care of all the aspects involved in the issue.

6. Penalty for Late Payment of Rent

In some agreements of financial leases, a penalty is imposed on the lessee in case he delays the payment of rent after the due date. This penalty, if meant to add to the income of the lessor, is not warranted by the Shari'ah. The reason is that the rent after it becomes due, is a debt payable by the lessee, and is subject to all the rules prescribed for a debt. A monetary charge from a debtor for his late payment is exactly the riba prohibited by the Holy Qur'an. Therefore, the lessor cannot charge an additional amount in case the lessee delays payment of the rent.

However, in order to avoid the adverse consequences resulting from the misuse of this prohibition, another alternative may be resorted to. The lessee may be asked to undertake that, if he fails to pay rent on its due date, he will pay certain amount to a charity. For this purpose the financier / lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to the needy persons. The amount payable for charitable purposes by the lessee may vary according to the period of default and may be calculated at per cent, per annum basis. The agreement of the lease may contain the following clause for this purpose:

> The Lessee hereby undertakes that, if he fails to pay rent at its due date, he shall pay an amount calculated at ....% p.a. to the charity Fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the Shari'ah and shall in no case form part of the income of the Lessor.

This arrangement, though does not compensate the lessor for his opportunity cost of the period of default, yet it may serve as a strong deterrent for the lessee to pay the rent promptly.

The justification for such undertaking of the lessee, and inability of any penalty or compensation claimed by the lessor for his own benefit is discussed in full in the chapter of murabahah in the present book which may be consulted for details.

7. Termination of Lease

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there

is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease' it has been noticed that the lessor has been given an unrestricted power to terminate the lease unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of Shari'ah.

In some agreements of the 'financial lease' a condition has been found to the effect that in case of the termination of lease, even at the option of the lessor, the rent of the remaining lease period shall be paid by the lessee. This condition is obviously against Shari'ah and the principles of equity and justice. The basic reason for inserting such conditions in the agreement of lease is that the main concept behind the agreement is to give an interest-bearing loan under the ostensible cover of lease. That is why every effort is made to avoid the logical consequences of the lease contract.

Naturally, such a condition cannot be acceptable to Shari'ah. The logical consequence of the termination of lease is that the asset should be taken back by the lessor. The lessee should be asked to pay the rent as due up to the date of termination. If the termination has been effected due to the misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be compelled to pay the rent of the remaining period.

8. Insurance of the Assets

If the leased property is insured under the Islamic mode of *takaful*, it should be at the expense of the lessor and not at the expense of the lessee, as is generally provided in the agreements of the current 'financial leases'.

9. The Residual Value of the Leased Asset

Another important feature of the modern 'financial leases' is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee. As the lessor already recovers his cost along with an additional profit thereon, which is normally equal to the amount of interest which could have been earned on a loan of that amount advanced for that period, the lessor has no

further interest in the leased asset. On the other hand, the lessee wants to retain the asset after the expiry of the leased period.

For these reasons, the leased asset is generally transferred to the lessee at the end of the lease, either free of any charge or at a nominal token price. In order to ensure that the asset will be transferred to the lessee, sometimes the lease contract has an express clause to this effect. Sometimes this condition is not mentioned in the contract expressly; however, it is understood between the parties that the title of the asset will be passed on to the lessee at the end of the lease term.

This condition, whether it is express or implied, is not in accordance with the principles of Shari‘ah. It is a well settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. Here the transfer of the asset at the end has been made a necessary condition for the transaction of lease which is not allowed in Shari‘ah.

The original position in Shari‘ah is that the asset shall be the sole property of the lessor, and after the expiry of the lease period, the lessor shall be at liberty to take the asset back, or to renew the lease or to lease it out to another party, or sell it to the lessee or to any other person. The lessee cannot force him to sell it to him at a nominal price, nor can such a condition be imposed on the lessor in the lease agreement.

But after the lease period expires, and the lessor wants to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will. However, some contemporary scholars, keeping in view the needs of the Islamic financial institutions have come up with an alternative. They say that the agreement of ijarah itself should not contain a condition of gift or sale at the end of the lease period. However, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. This promise will be binding on the lessor only. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed whereby the promisor is bound to fulfil the promise, but the promisee is not bound to enter into that contract . It means that he has an option to purchase which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise.

Therefore, these scholars suggest that the lessor, after entering into the lease agreement, can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the amounts of rentals and wants to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price.

Once this promise is signed by the lessor, he is bound to fulfil it and the lessee may exercise his option to purchase at the end of the period, if he has fully paid the amounts of rent according to the agreement of lease. Similarly, it is also allowed by these scholars that, instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. This arrangement is called '*ijarah wa iqtina*'. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this arrangement is subject to two basic conditions:

Firstly, the agreement of ijarah itself should not be subjected to signing this promise of sale or gift but the promise should he recorded in a separate document.

Secondly, the promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties because in this case it will be a full contract effected to a future date which is not allowed in the case of sale or gift.

10. Sub-Lease

If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor. If the lessor permits the lessee for subleasing, he may sub-lease it. If the rent claimed from the sub-lessee is equal to or less than the rent payable to the owner / original lessor, all the recognized schools of Islamic jurisprudence are unanimous on the permissibility of the sub lease. However, the opinions are different in case the rent charged from the sub-lessee is higher than the rent payable to the owner. Imam al-Shafi'i and some other scholars allow it and hold that the sub lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali school as well. On the other hand. Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible

for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus.[3]

Although the view of Imam Abu Hanifah is more precautious which should be acted upon to the best possible extent, in cases of need the view of Shafi'i and Hanbali schools may be followed because there is no express prohibition in the Holy Qur'an or in the Sunnah against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.

11. Assigning of the Lease

The lessor can sell the leased property to a third party whereby the relation of lessor and lessee shall be established between the new owner and the lessee. However, the assigning of the lease itself (without assigning the ownership in the leased asset) for a monetary consideration is not permissible.

The difference between the two situations is that in the latter case the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive the rent of the asset only. This kind of assignment is allowed in Shari'ah only where no monetary consideration is charged from the assignee for this assignment. for example, a lessor can assign his right to claim rent from the lessee to his son, or to his friend in the form of a gift. Similarly, he can assign this right to any one of his creditors to set off his debt out of the rentals received by him. But if the lessor wants to sell this right for a fixed price, it is not permissible, because in this case the money (the amount of rentals) is sold for money which is a transaction subject to the principle of equality. Otherwise it will be tantamount to a riba transaction, hence prohibited.

[3] See Ibn Qudamah, *Al-Mughni* (Riyadh, 1981), 5:475; Ibn 'Abidin, *Radd al-Muhtar*, 5:20.

Securitization of Ijarah

The arrangement of ijarah has a good potential of securitization which may help create a secondary market for the financiers on the basis of ijarah. Since the lessor in ijarah owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.[4]

Therefore, if the lessor, after entering into ijarah, wishes to recover his cost of purchase of the asset with a profit thereon, he can sell the leased asset wholly or partly either to one party or to a number of individuals. In the latter case, the purchase of a proportion of the asset by each individual may be evidenced by a certificate which may be called 'ijarah certificate'. This certificate will represent the holder's proportionate ownership in the leased asset and he will assume the rights and obligations of the owner/lessor to that extent. Since the asset is already leased to the lessee, lease will continue with the new owners, each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly he will also assume the obligations of the lessor to the extent of his ownership. Therefore, in the case of total destruction of the asset, he will suffer the loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded in freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.

It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue ijarah certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset. It means that the holder of such a certificate has no relation with the leased asset at all. His only

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[4] Some jurists are of the opinion that this sale will not take effect until the lease period is over. However, Imam Abu Yusuf and other jurists are of the view that the sale is valid, the purchaser will replace the seller, and ijarah may continue. (See Ibn 'Abidin, *Radd al-Muhtar*, 4:57)

right is to share the rentals received from the lessee. This type of securitization is not allowed in Shari'ah. As explained earlier in this chapter, the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in Shari'ah, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality, and if the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated. Therefore, this type of ijarah certificates cannot serve the purpose of creating a secondary market. It is, therefore, necessary that the ijarah certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.

Head-Lease

Another concept developed in the modern leasing business is that of 'head-leasing.' In this arrangement a lessee sub-leases the property to a number of sub-lessees. Then, he invites others to participate in his business by making them share the rentals received by his sub-lessees. For making them participate in receiving rentals, he charges a specified amount from them. This arrangement is not in accordance with the principles of Shari'ah. The reason is obvious. The lessee does not own the property. He is entitled to benefit from its usufruct only. That usufruct he has passed on to his sub-lessees by contracting a sub-lease with them. Now he does not own anything, neither the corpus of the property, nor its usufruct. What he has is the right to receive rent only. Therefore, he assigns a part of this right to other persons. It is already explained in detail that this right cannot be traded in, because it amounts to selling a receivable debt at a discount which is one of the forms of riba prohibited by the Holy Qur'an and Sunnah. Therefore, this concept is not acceptable.

These are some basic features of the 'financial lease' which are not in conformity with the dictates of Shari'ah. While using the lease as an Islamic mode of finance, these shortcomings must be avoided.

The list of the possible shortcomings in the lease agreement is not restricted to what has been mentioned above, but only the basic

errors found in different agreements have been pointed out, and the basic principles of Islamic leasing have been summarized. An Islamic lease agreement must conform to all of them.

7

Salam and Istisna'

It is one of the basic conditions for the validity of a sale in Shari'ah that the commodity (intended to be sold) must be in the physical or constructive possession of the seller. This condition has three ingredients:

Firstly, the commodity must be existing; therefore, a commodity which does not exist at the time of sale cannot be sold.

Secondly, the seller should have acquired the ownership of that commodity. Therefore, if the commodity is existing, but the seller does not own it, he cannot sell it to anybody.

Thirdly, mere ownership is not enough. It should have come in to the possession of the seller, either physically or constructively. If the seller owns a commodity, but he has not taken its delivery himself or through an agent, he cannot sell it.

There are only two exceptions to this general principle in Shari'ah. One is *salam* and the other is *istisna'*. Both are sales of a special nature, and in the present chapter the concept of these two kinds of sale and the extent to which they can be used for the purpose of financing will be explained.

Salam

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.

Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called "*rabb-us-salam*", the seller is "*muslam ilaih*", the cash price is "*ra's-ul-mal*" and the purchased commodity

is termed as "*muslam fih*", but for the purpose of simplicity, I shall use the English synonyms of these terms.

Salam was allowed by the Holy Prophet ﷺ subject to certain conditions. The basic purpose of this sale was to meet the needs of the small farmers who needed money to grow their crops and to feed their family upto the time of harvest. After the prohibition of riba they could not take usurious loans. Therefore, it was allowed for them to sell the agricultural products in advance.

Similarly, the traders of Arabia used to export goods to other places and to import some other goods to their homeland. They needed money to undertake this type of business. They could not borrow from the usurers after the prohibition of riba. It was, therefore, allowed for them that they sell the goods in advance. After receiving their cash price, they could easily undertake the aforesaid business.

Salam was beneficial to the seller, because he received the price in advance, and it was beneficial to the buyer also, because normally, the price in salam used to be lower than the price in spot sales. The permissibility of salam was an exception to the general rule that prohibits the forward sales, and therefore, it was subjected to some strict conditions. These conditions are summarized below:

Conditions of Salam

1. First of all, it is necessary for the validity of salam that the buyer pays the price in full to the seller at the time of effecting the sale. It is necessary because in the absence of full payment by the buyer, it will be tantamount to sale of a debt against a debt, which is expressly prohibited by the Holy Prophet ﷺ. Moreover, the basic wisdom behind the permissibility of salam is to fulfill the instant needs of the seller. If the price is not paid to him in full, the basic purpose of the transaction will be defeated. Therefore, all the Muslim jurists are unanimous on the point that full payment of the price is necessary in salam. However, Imam Malik is of the view that the seller may give a concession of two or three days to the buyers, but this concession should not form part of the agreement.[1]

[1] Ibn Qudamah, *Al-Mughni*, 4:328.

2. Salam can be effected in those commodities only the quality and quantity of which can be specified exactly. The things whose quality or quantity is not determined by specification cannot be sold through the contract of salam. For example, precious stones cannot be sold on the basis of salam, because every piece of precious stones is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.

3. Salam cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the salam will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery, and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity the supply of which is not certain.[2]

4. It is necessary that the quality of the commodity (intended to be purchased through salam) is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.

5. It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact measure should be known. What is normally weighed cannot be quantified in measures and vice versa.

6. The exact date and place of delivery must be specified in the contract.

7. Salam cannot be effected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to Shari'ah, that the delivery of both be simultaneous. Here, salam cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore the contract of salam in this case is not allowed. All the Muslim jurists are unanimous on the principle that salam will not be valid unless all these conditions are fully observed, because they are based on the express ahadith of the Holy

[2] See Ibn Qudamah, *Al-Mughni* (Riyadh, 1981), 4:325.

Prophet ﷺ. The most famous hadith in this context is the one in which the Holy Prophet ﷺ has said:

من أسلف شيء فليسلف كيل معلوم ، ووزن معلوم إ أجل معلوم

> Whoever wishes to enter into a contract of salam, he must effect the salam according to the specified measure and the specified weight and the specified date of delivery.[3]

However, there are certain other conditions which have been a point of difference between the different schools of the Islamic jurisprudence. Some of these conditions are discussed below:

(1) It is necessary, according to the Hanafi school, that the commodity (for which salam is effected) remains available in the market right from the day of contract upto the date of delivery. Therefore, if a commodity is not available in the market at the time of the contract, salam cannot be effected in respect of that commodity, even though it is expected that it will be available in the markets at the date of delivery.[4]

However, the other three schools of Fiqh (i.e. Shafi'i, Maliki, and Hanbali) are of the view that the availability of the commodity at the time of the contract is not a condition for the validity of salam. What is necessary, according to them, is that it should be available at the time of delivery.[5]

This view can be adopted in the present circumstances.[6]

(2) It is necessary, according to the Hanafi and Hanbali schools that the time of delivery is, at least, one month from the date of agreement. If the time of delivery is fixed earlier than one month, salam is not valid. Their argument is that salam has been allowed for the needs of small farmers and traders and therefore, they should be given enough opportunity to acquire the commodity. They may not be able to supply the commodity before one month. Moreover,

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[3] This hadith is reported by all the six famous books of hadith (see Ibn al-Hummam, *Fat-h al-Qadir*, 6:205).

[4] Al-Kasani, *Bada'i' al-Sana'i'*, 5:211.

[5] Ibn Qudamah, *Al-Mughni*, 4:326.

[6] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

the price in salam is normally lower than the price in spot sales. This concession in the price may be justified only when the commodities are delivered after a period which has a reasonable bearing on the prices. A period of less than one month does not normally affect the prices. Therefore, the minimum time of delivery should not be less than one month.[7]

Imam Malik supports the view that there should be a minimum period for the contract of salam. However, he is of the opinion that it should not be less than fifteen days, because the rates of the market may change within a fortnight.[8]

This view is, however, opposed by some other jurists, like Imam Shafi'i and some Hanafi jurists also.[9] They say that the Holy Prophet ﷺ has not specified a minimum period for the validity of salam. The only condition, according to the Hadith, is that the time of delivery must be clearly defined. Therefore, no minimum period can be prescribed. The parties may fix any date for delivery with mutual consent.

This view seems to be preferable in the present circumstances, because the Holy Prophet ﷺ has not prescribed a minimum period. The jurists have prescribed different periods which range between one day to one month. It is obvious that they have done so on the basis of expedience and keeping in view the interest of the poor sellers. But the expediency may differ from time to time and from place to place. Likewise, sometimes it is more in the interest of the seller to fix an earlier date. As far as the price is concerned, it is not a necessary ingredient of salam that the price is always lower than the market price on that day. The seller himself is the best judge of his interest, and if he accepts an earlier date of delivery with his free will and consent, there is no reason why he should be forbidden from doing so.

Certain contemporary jurists have adopted this view being more suitable for the modern transactions.[10]

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[7] Ibn Qudamah, *Al-Mughni*, 4:323.

[8] Al-Dardir, *Al-Sharh al-Saghir*, 3:275; al-Khurashi, 3:20.

[9] Ibn al-Hummam, *Fat-h al-Qadir*, 6:219.

[10] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

Salam as a Mode of Financing

It is evident from the foregoing discussion that salam was allowed by Shari'ah to fulfill the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector. As pointed out earlier, the price in salam may be fixed at a lower rate than the price of those commodities delivered at spot. In this way, the difference between the two prices may be a valid profit for the banks or financial institutions. In order to ensure that the seller shall deliver the commodity on the agreed date, they can also ask him to furnish a security, which may be in the form of a guarantee or in the form of mortgage or hypothecation.[11] In the case of default in delivery, the guarantor may be asked to deliver the same commodity, and if there is a mortgage, the buyer / the financier can sell the mortgaged property and the sale proceeds can be used either to realize the required commodity by purchasing it from the market, or to recover the price advanced by him.

The only problem in salam which may agitate the modern banks and financial institutions is that they will receive certain commodities from their clients, and will not receive money. Being conversant with dealing in money only, it seems to be cumbersome for them to receive different commodities from different clients and to sell them in the market. They cannot sell those commodities before they are actually delivered to them, because it is prohibited in Shari'ah.

But whenever we talk about the Islamic modes of financing, one basic point should never be ignored. The point is that the concept of the financial institutions dealing in money only is foreign to Islamic Shari'ah. If these institutions want to earn a halal profit, they shall have to deal in commodities in one way or the other, because no profit is allowed in Shari'ah on advancing loans only. Therefore, the establishment of an Islamic economy requires a basic change in the approach and in the outlook of the financial institutions. They shall have to establish a special cell for dealing in commodities. If such a special cell is established, it should not be

[11] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

difficult to purchase commodities through salam and to sell them in the spot markets.

However, there are two other ways of benefiting from the contract of salam.

Firstly, after purchasing a commodity by way of salam, the financial institutions may sell it through a parallel contract of salam for the same date of delivery. The period of salam in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction, and the difference between the two prices shall be the profit earned by the institution. The shorter the period of salam, the higher the price, and the greater the profit. In this way the institutions may manage their short term financing portfolios.

Secondly, if a parallel contract of salam is not feasible for one reason or another, they can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution, it will be sold to the third party at a pre-agreed price, according to the terms of the promise.

A third option is sometimes proposed that, at the date of delivery, the commodity is sold back to the seller at a higher price. But this suggestion is not in line with the dictates of Shari'ah. It is never permitted by the Shari'ah that the purchased commodity is sold back to the seller before the buyer takes its delivery, and if it is done at a higher price it will be tantamount to riba which is totally prohibited. Even if it is sold back to the seller after taking delivery from him, it cannot be pre-arranged at the time of original sale. Therefore, this proposal is not acceptable at all.

Some Rules of Parallel Salam

Since the modern Islamic Banks and Financial Institutions are using the instrument of parallel salam, some rules for the validity of this arrangement are necessary to observe:

1. In an arrangement of parallel salam, the bank enters into two different contracts. In one of them, the bank is the buyer and in the second one the bank is the seller. Each one of these contracts must

be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Each contract should have its own force and its performance should not be contingent on the other.

For example, if A has purchased from B 1000 bags of wheat by way of salam to be delivered on 31 December, A can contract a parallel salam with C to deliver to him 1000 bags of wheat on 31 December. But while contracting parallel salam with C, the delivery of wheat to C cannot be conditioned with taking delivery from B. Therefore, even if B did not deliver wheat on 31 December, A is duty bound to deliver 1000 bags of wheat to C. He can seek whatever recourse he has against B, but he cannot rid himself from his liability to deliver wheat to C.

Similarly, if B has delivered defective goods which do not conform with the agreed specifications, A is still obligated to deliver the goods to C according to the specifications agreed with him.

2. Parallel salam is allowed with a third party only. The seller in the first contract cannot be made purchaser in the parallel contract of salam, because it will be a buy-back contract, which is not permissible in Shari'ah. Even if the purchaser in the second contract is a separate legal entity, but it is fully owned by the seller in the first contract the arrangement will not be allowed, because in practical terms it will amount to 'buy-back' arrangement. For example A has purchased 1000 bags of wheat by way of salam from B, a joint stock company. B has a subsidiary C, which is a separate legal entity but is fully owned by B. A cannot contract the parallel salam with C. However, if C is not wholly owned by B, A can contract parallel salam with it, even if some share-holders are common between B and C.

Istisna'

'*Istisna'*' is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of istisna' comes into existence. But it is necessary for the validity of istisna' that the

price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of istisna' creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving a notice to the other.[12] However after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

Difference Between Istisna' and Salam

Keeping in view this nature of istisna' there are several points of difference between istisna' and salam which are summarized below:

(i) The subject of istisna' is always a thing which needs manufacturing, while salam can be effected on any thing, no matter whether it needs manufacturing or not.

(ii) It is necessary for salam that the price is paid in full in advance, while it is not necessary in istisna'.

(iii) The contract of salam, once effected, cannot be cancelled unilaterally, while the contract of istisna' can be cancelled before the manufacturer starts the work.

(iv) The time of delivery is an essential part of the sale in salam while it is not necessary in istisna' that the time of delivery is fixed.[13]

Difference Between Istisna' and Ijarah

It should also be kept in mind that the manufacturer, in istisna', undertakes to make the required goods with his own material. Therefore, this transaction implies that the manufacturer shall obtain the material, if it is not already with him, and shall undertake the work required for making the ordered goods with it. If the material is provided by the customer, and the manufacturer is required to use his labor and skill only, the transaction is not istisna'. In this case it will be a transaction of ijarah whereby the services of a person are hired for a specified fee paid to him.[14]

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[12] Ibn 'Abidin, *Radd al-Muhtar*, 5:223.
[13] Ibid., 5:225.
[14] Khalid al-Atasi, *Sharh al-Majallah*, 2:403.

When the required goods have been manufactured by the seller, he should present them to the purchaser. But there is a difference of opinion among the Muslim jurists whether or not the purchaser has a right to reject the goods at this stage. Imam Abu Hanifah is of the view that he can exercise his 'option of seeing' (*khiyar-ur-ru'yah*) after seeing the goods, because istisna' is a sale and if somebody purchases a thing which is not seen by him, he has the option to cancel the sale after seeing it. The same principle is also applicable to istisna'.

However, Imam Abu Yusuf says that if the commodity conforms to the specifications agreed upon between the parties at the time of the contract, the purchaser is bound to accept the goods and he cannot exercise the option of seeing. This view has been preferred by the jurists of the Ottoman Empire, and the Hanafi law has been codified according to this view, because it is damaging in the context of modern trade and industry that after the manufacturer has used all his resources to prepare the required goods, the purchaser cancels the sale without assigning any reason, even though the goods are in full conformity with the required specifications.[15]

Time of Delivery

As pointed out earlier, it is not necessary in istisna' that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and to pay the price.[16]

In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on daily basis. Can such a penal clause be inserted in a contract of istisna' according to Shari'ah? Although the classical jurists seem to be silent about this question while they discuss the contract of istisna', yet they have allowed a similar

[15] See *Majallah*, sec. 392 and the introduction.
[16] Ibn 'Abidin, *Radd al-Muhtar*, 5:225.

condition in the case of ijarah. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares them after two days.[17]

On the same analogy, the price in istisna' may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.

Istisna' as a Mode of Financing

Istisna' can be used for providing the facility of financing in certain transactions, especially in the house finance sector. If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house at that open land, on the basis of istisna', and if the client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house on a specified piece of land.

Since it is not necessary in istisna' that the price is paid in advance, nor is it necessary that it is paid at the time of delivery, (it may be deferred to any time according to the agreement of the parties)[18], therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in installments.

On the other hand, it is not necessary that the financier himself constructs the house. He can enter into a parallel contract of istisna' with a third party, or may hire the services of a contractor (other than the client). In both cases, he can calculate his cost and fix the price of istisna' with his client in a manner which may give him a reasonable profit over his cost. The payment of installments by the client may start, in this case, right from the day when the contract of istisna' is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. In order to secure the payment of the installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security, until the last installment is paid by the client.

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[17] Ibid., 3:311.

[18] Al-Atasi, *Sharh al-Majallah*, 2:406.

The financier, in this case, will be responsible for the construction of the house in full conformity with the specifications detailed in the agreement. In the case of any discrepancy, the financier will undertake such alteration at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

The instrument of istisna' may also be used for project financing on similar lines. If a client wants to install an air-conditioning plant in his factory, and the plant needs to be manufactured, the financier may undertake to prepare the plant through the contract of istisna' according to the aforesaid procedure. Similarly, the contract of istisna' can be used for building a bridge or a highway.

The modern BOT (Buy, Operate and Transfer) agreements may also be formalized on the basis of istisna'. If a government wants to construct a highway, it may enter into a contract of istisna' with a builder. The price of istisna', in this case, may be the right of the builder to operate the highway and collect tolls for a specified period.

8

Islamic Investment Funds

The term "Islamic Investment Fund" in this chapter means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profits in strict conformity with the precepts of Islamic Shari'ah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Shari'ah, will always be subject to two basic conditions:

Firstly, instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Fund, will be liable to compensate it.

Secondly, the amounts so pooled together must be invested in a business acceptable to Shari'ah. It means that not only the channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment which are discussed briefly in the following paragraphs

Equity Fund

In an equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

It is obvious that if the main business of a company is not lawful in terms of Shari‘ah, it is not allowed for an Islamic Fund to purchase, hold or sell its shares, because it will entail the direct involvement of the share holder in that prohibited business.

Similarly the contemporary Shari‘ah experts are almost unanimous on the point that if all the transactions of a company are in full conformity with Shari‘ah, which includes that the company neither borrows money on interest nor keeps its surplus in an interest bearing account, its shares can be purchased, held and sold without any hindrance from the Shari‘ah side. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock markets are in some way involved in an activity which violates the injunctions of Shari‘ah. Even if the main business of a company is halâl, its borrowings are based on interest’. On the other hand, they keep their surplus money in an interest bearing account or purchase interest-bearing bonds or securities.

The case of such companies has been a matter of debate between the Shari‘ah experts in the present century. A group of the Shari‘ah experts is of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is halâl. Their basic argument is that every share-holder of a company is a *sharîk* (partner) of the company, and every *sharîk*, according to the Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the share-holder to the company to carry on its business in whatever manner the management deems fit. If it is known to the share-holder that

the company is involved in an un-Islamic transaction, and still he holds the shares of that company, it means that he has authorized the management to proceed with that UN-Islamic transaction. In this case, he will not only be responsible for giving his consent to an UN-Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

Moreover, when a company is financed on the basis of interest, its funds employed in the business are impure. Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income which will be distributed to the share-holders through dividends.

However, a large number of the present day scholars do not endorse this view. They argue that a joint stock company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all the partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the policy decisions in a joint stock company are taken by the majority. Being composed of a large number of share-holders, a company cannot give a veto power to each share-holder. The opinions of individual share-holders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every share-holder in his individual capacity. If a share-holder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a halâl business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

The other aspect of the dealings of such a company is that it sometimes borrows money from financial institutions. These borrowings are mostly based on interest. Here again the same principle is relevant. If a share-holder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as harâm or impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who willfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful

Conditions for Investment in Shares

In the light of the foregoing discussion, dealing in equity shares can be acceptable in Shari'ah subject to the following conditions:

1. The main business of the company is not violative of Shari'ah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shari'ah, such as companies manufacturing, selling or offering liquors, pork, harâm meat, or involved in gambling, night club activities, pornography etc.

2. If the main business of the companies is halâl, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given in charity, and must not be retained by him. For example, if 5% of the whole

income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

4. The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of illquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

للأكثر حكم الكل

The majority deserves to be treated as the whole of a thing.

Some other scholars have opined that even if the illiquid asset of a company are 33%, its shares can be treated as negotiable.

The third view is based on the Hanafi jurisprudence. The principle of the Hanafi school is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

Firstly, the illiquid part of the combination must not be in ignore-able quantity. It means that it should be in a considerable proportion.

Secondly, the price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed as 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed as 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the

definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed as 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Subject to these conditions, the purchase and sale of shares is permissible in Shari'ah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in Shari'ah as partners inter se. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

The Shari'ah scholars have different views about whether the 'purification' is necessary where the profits are made through capital gains (i.e. by purchasing the shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of the price can be allocated for the interest received by the company. It is obvious that if all the above requirements of the halâl shares are observed, then most of the assets of the company are halâl, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also ignore-able as compared to bulk of the assets of the company. Therefore, the price of the share, in fact, is against bulk of the assets,

and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the halâl assets only.

Although this second view is not without force, yet the first view is more precautious and far from doubts. Particularly, it is more equitable in an open-ended equity fund, because if the purification is not carried out on the appreciation and a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his unit after some dividends have been received in the fund and the amount of purification has been deducted therefrom, reducing the net asset value per unit, he will get a lesser price as compared to the first person.

On the contrary, if purification is carried out both on dividends and on capital gains, all the unit-holders will be treated at par with regard to the deduction of the amounts of purification. Therefore, it is not only free from doubts but also more equitable for all the unit-holders to carry out purification in the capital gains also. This purification may be carried out on the basis of an average percentage of the interest earned by the companies included in the portfolio.

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as mudâribs for the subscribers. In this case a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary Shari'ah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the

management will get 2% or 3% of the net asset value of the fund 1[1] at the end of every financial year.

However, it is necessary in Shari'ah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

Ijarah Fund

Another type of Islamic Fund may be an ijârah fund. Ijârah means leasing the detailed rules of which have already been discussed in the third chapter of this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro rata to the subscribers.

Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called '*sukûk*'—a term recognized in the traditional Islamic jurisprudence. Since these sukûk represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these sukûk replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these sukûk will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of Shari'ah which substantially differ from the terms and conditions used in the agreements of

[1] This way may be justified on the analogy of *simsâr* (broker) for whom the fee based on percentage is allowed.

conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.

2. The leased assets must be of a nature that their halâl (permissible) use is possible.

3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.

4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of mudârabah, because mudârabah, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali school, mudârabah can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

Commodity Fund

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund which is distributed pro rata among the subscribers.

In order to make this fund acceptable to Shari'ah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The commodity must be owned by the seller at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shari'ah.

2. Forward sales are not allowed except in the case of salam and istisnâ' (For their full details the previous chapter of this book may be consulted).

3. The commodities must be halâl. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.

4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).

5. The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied up with an uncertain event renders the sale invalid.

In view of the above and similar other conditions, more fully described in the second chapter of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shari'ah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

Murabahah Fund

Murabahah is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of murabahah, as undertaken by the present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabahah does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable

debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

Bai'-Al-Dain

Here comes the question whether or not *bai'-al-dain* is allowed in Sharî'ah. *Dain* means 'debt' and *bai'* means sale. Bai'-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in Sharî'ah as Bai'-al-dain. The traditional Muslim jurists (fuqahâ') are unanimous on the point that bai'al-dain with discount is not allowed in Shari'ah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shâfi'ite school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shâfi'ite jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of bai'-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shari'ah.

Some scholars argue that the permissibility of bai'-al-dain is restricted to a case where the debt is created through the sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shari'ah scholars and has the representation of all the Muslim

countries, including Malaysia, has approved the prohibition of bai'-al-dain unanimously without a single dissent.

Mixed Fund

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.

9

The Principle of Limited Liability

The concept of 'limited liability' has now become an inseparable ingredient of the large scale enterprises of trade and industry throughout the modern world, including the Muslim countries. The present chapter aims to explain this concept and evaluate it from the Shari'ah point of view in order to know whether or not this principle is acceptable in a pure Islamic economy. The limited liability' in the modern economic and legal terminology is a condition under which a partner or a shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company or partner-ship with limited liability. If the business incurs a loss, the maximum a shareholder can suffer, is that he may lose his entire original investment. But the loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors cannot claim the remaining part of their receivables from the personal assets of the shareholders.

Although the concept of 'limited liability' was, in some countries applied to the partnership also, yet, it was most commonly applied to the companies and corporate bodies. Rather, it will be more true, perhaps, to say that the concept of 'limited liability' originally emerged with the emergence of the corporate bodies and joint stock companies. The basic purpose of the introduction of this principle was to attract the maximum number of investors to the large-scale joint ventures and to assure them that their personal

fortunes will not be at stake if they wish to invest their savings in such a joint enterprise. In the practice of modern trade, the concept proved itself to be a vital force to mobilize large amounts of capital from a wide range of investors.

No doubt, the concept of 'limited liability' is beneficial to the shareholders of a company. But, at the same time, it may be injurious to its creditors. If the liabilities of a limited company exceed its assets, the company becomes insolvent and is consequently liquidated, the creditors may lose a considerable amount of their claims, because they can only receive the liquidated value of the assets of the company, and have no recourse to its shareholders for the rest of their claims. Even the directors of the company who may be responsible for such an unfortunate situation cannot be held responsible for satisfying the claims of the creditors. It is this aspect of the concept of 'limited liability' which requires consideration and research from the Shari'ah viewpoint.

Although the concept of 'limited liability' in the context of the modern commercial practice is a new concept and finds no express mention as such in the original sources of Islamic Fiqh, yet the Shari'ah viewpoint about it can be sought in the principles laid down by the Holy Qur'an, the Sunnah of the Holy Prophet ﷺ and the Islamic jurisprudence. This exercise requires some sort of *ijtihad* carried out by the persons qualified for it. This ijtihad should preferably be undertaken by the Shari'ah scholars at a collective level, yet, as a pre-requisite, there should be some individual efforts which may serve as a basis for the collective exercise.

As a humble student of Shari'ah, this author have been considering the issue since long, and what is going to be presented in this article should not be treated as a final verdict on this subject, nor an absolute opinion on the point. It is the outcome of initial thinking on the subject, and the purpose of this article is to provide a foundation for further research.

The question of 'limited liability' it can be said, is closely related to the concept of juridical personality of the modern corporate bodies. According to this concept, a joint-stock company in itself enjoys the status of a separate entity as distinguished from the individual entities of its shareholders. The separate entity as a fictive person has legal personality and may thus sue and be sued, may

make contracts, may hold property in its name, and has the legal status of a natural person in all its transactions entered into in the capacity of a juridical person.

The basic question, it is believed, is whether the concept of a 'juridical person' is acceptable in Shari'ah or not. Once the concept of 'juridical person' is accepted and it is admitted that, despite its fictive nature, a juridical person can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of 'limited liability' which will follow as a logical result of the former concept. The reason is obvious. If a real person i.e. a human being dies insolvent, his creditors have no claim except to the extent of the assets he has left behind. If his liabilities exceed his assets, the creditors will certainly suffer, no remedy being left for them after the death of the indebted person.

Now, if we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming insolvent, is bound to be liquidated: and the liquidation of a company corresponds to the death of a person, because a company after its liquidation, cannot exist any more. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation.

Therefore, the basic question is whether or not the concept of 'juridical person' is acceptable to Shari'ah. Although the idea of a juridical person, as envisaged by the modern economic and legal systems has not been dealt with in the Islamic Fiqh, yet there are certain prcedents wherefrom the basic concept of a juridical person may be derived by inference.

Waqf

The first precedent is that of a *Waqf*. The Waqf is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as Waqf, no longer remain in the ownership of the donor. The beneficiaries of a Waqf can benefit from the corpus

or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone.

It seems that the Muslim jurists have treated the Waqf as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. This will be clear from two rulings given by the fuqaha' (Muslim jurists) in respect of Waqf.

Firstly, if a property is purchased with the income of a Waqf, the purchased property cannot become a part of the Waqf automatically. Rather, the jurists say, the property so purchased shall be treated as a property owned by the Waqf.[1] It clearly means that a Waqf, like a natural person, can own a property.

Secondly, the jurists have clearly mentioned that the money given to a mosque as donation does not form part of the Waqf, but it passes to the ownership of the mosque. [2]

Here again the mosque is accepted to be an owner of money. This principle has been expressly mentioned by some jurists of the Maliki school also. They have stated that a mosque is capable of being the owner of something. This capability of the mosque, according to them, is constructive, while the capability enjoyed by a human being is physical.[3]

Another renowned Maliki jurist, namely, Ahmad Al-Dardir, validates a bequest made in favour of a mosque, and gives the reason that a mosque can own properties. Not only this, he extends the principle to an inn and a bridge also, provided that they are Waqf.

It is clear from these examples that the Muslim jurists have accepted that a Waqf can own properties. Obviously, a Waqf is not a human being, yet they have treated it as a human being in the matter of ownership. Once its ownership it established, it will logically follow that it can sell and purchase, may become a debtor and a creditor and can sue and be sued, and thus all the characteristics of a 'juridical person' can be attributed to it.

Baitul-Mal

Another example of 'juridical person' found in our classic literature of Fiqh is that of the *Baitul-mal* (the exchequer of an Islamic state).

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[1] *Al-Fatawa al-Hindiyyah*, Waqf, Ch. 5, 2:417.

[2] Ibid., 3:240. See also *I'lā' al-Sunan*, 13:198.

[3] See al-Khurashi's commentary on *Mukhtasar al-Khalil*, 7:80.

Being public property, all the citizens of an Islamic state have some beneficial right over the Baitul-mal, yet, nobody can claim to be its owner. Still, the Baitul-mal has some rights and obligations. Imam Al-Sarakhsi, the well-known Hanafi jurist, says in his work "Al-Mabsut":

> The Baitul-mal has some rights and obligations which may possibly be undetermined.[4]

At another place the same author says:

> If the head of an Islamic state needs money to give salaries to his army, but he finds no money in the Kharaj department of the Baitul-mal (wherefrom the salaries are generally given) he can give salaries from the sadaqah (Zakah) department, but the amount so taken from the sadaqah department shall be deemed to be a debt on the Kharaj department.[5]

It follows from this that not only the Baitul-mal, but also the different departments therein can borrow and advance loans to each other. The liability of these loans does not lie on the head of state, but on the concerned department of Baitul-mal. It means that each department of Baitul-mal is a separate entity and in that capacity it can advance and borrow money, may be treated a debtor or a creditor, and thus can sue and be sued in the same manner as a juridical person does. It means that the Fuqaha of Islam have accepted the concept of juridical person in respect of Baitul-mal.

Joint Stock

Another example very much close to the concept of 'juridical person' in a joint stock company is found in the Fiqh of Imam Shafi'i. According to a settled principle of Shafi'i School, if more than one person run their business in partner-ship, where their assets are mixed with each other, the zakah will be levied on each of them individually, but it will be payable on their joint-stock as a whole, so much so that even if one of them does not own the

[4] Al-Sarakhsi, *al-Mabsut*, 14:33.
[5] Ibid., 3:18.

amount of the nisab, but the combined value of the total assets exceeds the prescribed limit of the nisab, zakah will be payable on the whole joint-stock including the share of the former, and thus the person whose share is less than the nisab shall also contribute to the levy in proportion to his ownership in the total assets, whereas he was not subject to the levy of zakah, had it been levied on each person in his individual capacity.

The same principle, which is called the principle of '*Khultah-al-Shuyu*' is more forcefully applied to the levy of Zakah on the livestock. Consequently, a person sometimes has to pay more Zakah than he was liable to in his individual capacity, and sometimes he has to pay less than that.

That is why the Holy Prophet ﷺ has said:

لا مع ب متفرق ولا يفرق ب تمع افة الصدقة

'The separate assets should not be joined together nor the joint assets should be separated in order to reduce the amount of Zakah levied on them.

This principle of 'Khultah-al-Shuyu'' which is also accepted to some extent by the Maliki and Hanbali schools with some variance in details, has a basic concept of a juridical person underlying it. It is not the individual, according to this principle, who is liable to Zakah. It is the 'joint-stock' which has been made subject to the levy. It means that the 'joint-stock' has been treated a separate entity, and the obligation of 'zakah has been diverted towards this entity which is very close to the concept of a 'juridical person', though it is not exactly the same.

Inheritance under Debt

The fourth example is the property left by a deceased person whose liabilities exceed the value of all the property left by him. For the purpose of brevity we can refer to it as 'inheritance under debt'.

According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place.

They have their claims over it, but it is not their property unless it is actually divided between them. Being property of nobody, it has its own existence and it can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the property as managers, but they are not the owners. If the process of the settlement of debt requires some expenses, the same will be met by the property itself.

Looked at from this angle, this 'inheritance under debt' has its own entity which may sell and purchase, becomes debtor and creditor, and has the characteristics very much similar to those of a 'juridical person.' Not only this, the liability of this 'juridical person' is certainly limited to its existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

These are some instances where the Muslim jurists have affirmed a legal entity, similar to that of a juridical person. These examples would show that the concept of 'juridical person' is not totally foreign to the Islamic jurisprudence, and if the juridical entity of a joint-stock company is accepted on the basis of these precedents, no serious objection is likely to be raised against it.

As mentioned earlier, the question of limited liability of a company is closely related to the concept of a 'juridical person'. If a 'juridical person' can be treated a natural person in its rights and obligations, then, every person is liable only to the limit of the assets he owns, and in case he dies insolvent no other person can bear the burden of his remaining liabilities, however closely related to him he may be. On this analogy the limited liability of a joint-stock company may be justified.

The Limited Liability of the Master of a Slave

Here I would like to cite another example with advantage, which is the closest example to the limited liability of a joint-stock company. The example relates to a period of our past history when slavery was in vogue, and the slaves were treated as the property of their masters and were freely traded in. Although the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurists while dealing with various

questions pertaining to the trade of slaves are still beneficial to a student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems and in this respect, it is believed that this example is the most relevant to the question at issue. The slaves in those days were of two kinds. The first kind was of those who were not permitted by their masters to enter into any commercial transaction. A slave of this kind was called '*qinn*'. But there was another kind of slaves who were allowed by their masters to trade. A slave of this kind was called العبـد المـأذون. The initial capital for the purpose of trade was given to such a slave by his master, but he was free to enter into all the commercial transactions. The capital invested by him totally belonged to his master. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave, and the slave would die in that state of indebtedness, the creditors could not approach his master for the rest of their claims.

Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master.

This is the nearest example found in the Islamic Fiqh which is very much similar to the limited liability of the share holders of a company, which can be justified on the same analogy. On the basis of these five precedents, it seems that the concepts of a juridical person and that of limited liability do not contravene any injunction of Islam. But at the same time, it should be emphasized, that the concept of 'limited liability' should not be allowed to work for cheating people and escaping the natural liabilities consequent to a profitable trade. So, the concept could be restricted, to the

public companies only who issue their shares to the general public and the number of whose shareholders is so large that each one of them cannot be held responsible for the day-to-day affairs of the business and for the debts exceeding the assets.

As for the private companies or the partnerships, the concept of limited liability should not be applied to them, because, practically, each one of their shareholders and partners can easily acquire a knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities. There may be an exception for the sleeping partners or the shareholders of a private company who do not take part in the business practically and their liability may be limited as per agreement between the partners. If the sleeping partners have a limited liability under this agreement, it means, in terms of Islamic jurisprudence, that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if the debts of the business increase from the specified limit, it will be the sole responsibility of the working partners who have exceeded the limit.

The upshot of the foregoing discussion is that the concept of limited liability can be justified, from the Shari'ah viewpoint, in the public joint-stock companies and those corporate bodies only who issue their shares to general public. The concept may also be applied to the sleeping partners of a firm and to the shareholders of a private company who take no active part in the business management. But the liability of the active partners in a partnership and active shareholders of a private company should always be unlimited.

At the end, we should again recall what has been pointed out at the outset. The issue of limited liability, being a modern issue which requires a collective effort to find out its solution in the light of Shari'ah, the above discussion should not be deemed to be a final verdict on the subject. This is only the outcome of an initial thinking which always remains subject to further study and research.

10

The Performance of the Islamic Banks — A Realistic Evaluation

Islamic banking has become today an undeniable reality. The number of Islamic banks and the financial institutions is ever increasing. New Islamic Banks with huge amount of capital are being established. Conventional banks are opening Islamic windows or Islamic subsidiaries for the operations of Islamic banking. Even the non-Muslim financial institutions are entering the field and trying to compete each other to attract as many Muslim customers as they can. It seems that the size of Islamic banking will be at least multiplied during the next decade and the operation of Islamic banks are expected to cover a large area of financial transactions of the world. But before the Islamic financial institutions expand their business they should evaluate their performance during the last two decades because every new system has to learn from the experience of the past, to revise its activities and to analyze its deficiencies in a realistic manner. Unless we analyze our merits and demerits we cannot expect to advance towards our total success. It is in this perspective that we should seek to analyze the operation of Islamic banks and financial institutions in the light of Shari'ah and to highlight what they have achieved and what they have missed.

Once during a press conference in Malaysia, this author was asked the question about the contribution of the Islamic Banks in

promoting the Islamic economy. My reply to the question was apparently contradictory, I said it he has contributed a lot and they have contributed nothing. In the present chapter an attempt has been made to elaborate upon this reply. When it was said that they have contributed a lot, what was meant is that it was a remarkable achievement of the Islamic banks that they have made a great breakthrough in the present banking system by establishing Islamic financial institutions meant to follow Shari'ah. It was a cherished dream of the Muslim Ummah to have an interest-free economy, but the concept of Islamic banking was merely a theory discussed in research papers, having no practical example. It was the Islamic banks and financial institutions which translated the theory into practice and presented a living and practical example for the theoretical concept in an environment where it was claimed that no financial institution can work without interest. It was indeed a courageous step on the part of the Islamic banks to come forward with a firm resolution that all their transactions will conform to Shari'ah and all their activities will be free from all transactions involving interest.

Another major contribution of the Islamic banks is that, being under supervision of their respective Shari'ah Boards they presented a wide spectrum of questions relating to modern business, to the Shari'ah scholars, thus providing them with an opportunity not only to understand the contemporary practice of business and trade but also to evaluate it in the light of Shari'ah and to find out other alternatives which may be acceptable according to the Islamic principles.

It must be understood that when we claim that Islam has a satisfactory solution for every problem emerging in any situation in all times to come, we do not mean that the Holy Qur'an or the Sunnah of the Holy Prophet ﷺ or the rulings of the Islamic scholars provide a specific answer to each and every minute detail of our socio-economic life. What we mean is that the Holy Qur'an and the Holy Sunnah of the Prophet ﷺ have laid down broad principles in the light of which the scholars of every time have deduced specific answers to the new situation arising in their age. Therefore, in order to reach a definite answer about a new situation the scholars of Shari'ah have to play a very important role. They

have to analyze every new question in the light of the principles laid down by the Holy Qur'an and Sunnah as well as in the light of the standards set by the earlier jurists, enumerated in the books of Islamic jurisprudence. This exercise is called *istinbat* or *ijtihad*. It is this exercise which has enriched the Islamic jurisprudence with a wealth of knowledge and wisdom for which no parallel is found in any other religion. In a society where the Shari'ah is implemented in its full sway the ongoing process of *istinbat* keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence which makes it easier to find out specific answer to almost every situation in the books of Islamic jurisprudence. But during the past few centuries the political decline of the Muslims stopped this process to a considerable extent. Most of the Islamic countries were captured by non-Muslim rulers who by enforcing with power the secular system of government, deprived the socio-economic life from the guidance provided by the Shari'ah, and the Islamic teachings were restricted to a limited sphere of worship, religious education and in some countries to the matter of marriage, divorce and inheritance only. So far as the political and economic activities are concerned the governance of Shari'ah was totally rejected.

Since the evolution of any legal system depends on its practical application, the evolution of Islamic law with regard to business and trade was hindered by this situation. Almost all the transactions in the market being based on secular concepts were seldom brought to the Shari'ah scholars for their scrutiny in the light of Shari'ah. It is true that even in these days some practicing Muslims brought some practical questions before the Shari'ah scholars for which the scholars have been giving their rulings in the forms of fatawas of which a substantial collection is still available. However, all these fatawas related mostly to the individual problems of the relevant persons and addressed their individual needs.

It is a major contribution of the Islamic banks that, because of their entry into the field of large scale business, the wheel of evolution of Islamic legal system has re-started. Most of the Islamic banks are working under the supervision of their Shari'ah Boards. They bring their day to day problems before the Shari'ah scholars who examine them in the light of Islamic rules and principles and give specific rulings about them. This procedure not only makes

Shari'ah scholars more familiar with the new market situation but also through their exercise of istinbat contributes to the evolution of Islamic jurisprudence. Thus, if a practice is held to be un-Islamic by the Shari'ah scholars a suitable alternative is also sought by the joint efforts of the Shari'ah scholars and the management of the Islamic banks. The resolutions of the Shari'ah Boards have by now produced dozens of volumes—a contribution which can never be under-rated.

Another major contribution of the Islamic banks is that they have now asserted themselves in the international market, and Islamic banking as distinguished from conventional banking is being gradually recognized throughout the world. This is how I explain my comment that they have contributed a lot. On the other hand there are a number of deficiencies in the working of the present Islamic banks which should be analyzed with all seriousness.

First of all, the concept of Islamic banking was based on an economic philosophy underlying the rules and principles of Shari'ah. In the context of interest-free banking this philosophy aimed at establishing distributive justice free from all sorts of exploitation. As I have explained in a number of articles, the instrument of interest has a constant tendency in favor of the rich and against the interests of the common people. The rich industrialists by borrowing huge amounts from the bank utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of a meager rate of interest and this is also taken by them by adding it to the cost of their products. Therefore, looked at from macro level, they pay nothing to the depositors. While in the extreme cases of losses which lead to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth.

Contrary to this is the case of Islamic financing. The ideal instrument of financing according to Shari'ah is musharakah where the profits and losses both are shared by both the parties according to equitable proportion. Musharakah provides better opportunities for the depositors to share actual profits earned by the business which in normal cases may be much higher than the rate of interest. Since the profits cannot be determined unless the relevant

commodities are completely sold, the profits paid to the depositors cannot be added to the cost of production, therefore, unlike the interest-based system the amount paid to the depositors cannot be claimed back through increase in the prices.

This philosophy cannot be translated into reality unless the use of the musharakah is expanded by the Islamic banks. It is true that there are practical problems in using the musharakah as a mode of financing especially in the present atmosphere where the Islamic banks are working in isolation and, mostly without the support of their respective governments. The fact, however, remains that the Islamic banks should have gressed towards musharakah in gradual phases and should have increased the size of musharakah financing. Unfortunately, the Islamic banks have overlooked this basic requirement of Islamic banking and there are no visible efforts to progress towards this transaction even in a gradual manner even on a selective basis. This situation has resulted in a number of adverse factors :

Firstly, the basic philosophy of Islamic banking seems to be totally neglected.

Secondly, by ignoring the instrument of musharakah the Islamic banks are forced to use the instrument of murabahah and ijarah and these too, within the framework of the conventional benchmarks like Libber etc. where the net result is not materially different from the interest based transactions. I do not subscribe to the view of those people who do not find any difference between the transactions of conventional banks and murabahah and ijarah and who blame the instruments of murabahah and ijarah for perpetuating the same business with a different name, because if murabahah and ijarah are implemented with their necessary conditions, they have many points of difference which distinguish them from interest-based transactions. However, one cannot deny that these two transactions are not originally modes of financing in Shari‘ah. The Shari‘ah scholars have allowed their use for financing purposes only in those spheres where musharakah cannot work and that too with certain conditions. This allowance should not be taken as a permanent rule for all sorts of transactions and the entire operations of Islamic Banks should not revolve around it.

Thirdly, when people realize that income from in the transactions undertaken by Islamic banks is dubious akin to the

transactions of conventional banks, they become skeptical towards the functioning of Islamic banks.

Fourthly, if all the transactions of Islamic banks are based on the above devices it becomes very difficult to argue for the case of Islamic banking before the masses especially, before the non-Muslims who feel that it is nothing but a matter of twisting of documents only.

It is observed in a number of Islamic banks that even murabahah and ijarah are not effected according to the procedure required by the Shari'ah. The basic concept of murabahah was that the bank should purchase the commodity and then sell it to the customer on deferred payment basis at a margin of profit. From the Shari'ah point of view it is necessary that the commodity should come into the ownership and at least in the constructive possession of the bank before it is sold to the customer. The bank should bear the risk of the commodity during the period it is owned and possessed by the bank. It is observed that many Islamic banks and financial institutions commit a number of mistakes with regard to this transaction:

Some financial institutions have presumed that murabahah is the substitute for interest, for all practical purposes. Therefore, they contract a murabahah even when the client wants funds for his overhead expenses like paying salaries or bills for the goods and services already consumed. Obviously murabahah cannot be effected in this case because no commodity is being purchased by the bank.

In some cases the client purchases the commodity on his own prior to any agreement with the Islamic Bank and a murabahah is effected on a buy-back basis. This is again contrary to the Islamic principles because the buy-back arrangement is unanimously held as prohibited in Shari'ah.

In some cases the client himself is made an agent for the bank to purchase a commodity and to sell it to himself immediately after acquiring the commodity. This is not in accordance with the basic conditions of the permissibility of murabahah. If the client himself is made an agent to purchase the commodity, his capacity as an agent must be distinguished from his capacity as a buyer which means that after purchasing commodity on behalf of the bank he must inform the bank that he has effected the purchase on its behalf

and then the commodity should be sold to him by the bank through a proper offer and acceptance which may be effected through the exchange of telexes or faxes.

As explained earlier murabahah is a kind of sale and it is an established principle of Shari'ah that the price must be determined at the time of sale. This price can neither be increased nor reduced unilaterally once it is fixed by the parties. It is observed that some financial institutions increase the price of murabahah in the case of late payment which is not allowed in Shari'ah. Some financial institutions roll-over the murabahah in the case of default by the client. Obviously, this practice is not warranted by Shari'ah because once the commodity is sold to the customer it cannot be the subject matter of another sale to the same customer.

In transactions of ijarah also some requirements of Shari'ah are often overlooked. It is a prerequisite for a valid ijarah that the lessor bears the risks related to the ownership of the leased asset and that the usufruct of the leased asset must be made available to the lessee for which he pays rent. It is observed in a number of ijarah agreements that these rules are violated. Even in the case of destruction of the asset due to force majeure, the lessee is required to keep paying the rent which means that the lessor neither assumes the liability for his ownership nor offers any usufruct to the lessee. This type of ijarah is against the basic principles of Shari'ah.

The Islamic banking is based on principles different from those followed in conventional banking system. It is therefore logical that the results of their operations are not necessarily the same in terms of profitability. An Islamic bank may earn more in some cases and may earn less in some others. If our target is always to match the conventional banks in terms of profits, we can hardly develop our own products based on pure Islamic principles. Unless the sponsors of the bank as well as its management and its clientele realize this fact and are ready to accept different - but not necessarily adverse - results, the Islamic banks will keep using artificial devices and a true Islamic system will not come into being.

According to the Islamic principles, business transactions can never be separated from the moral objectives of the society. Therefore, Islamic banks were supposed to adopt new financing policies and to explore new channels of investments which may encourage development and support the small scale traders to lift up

their economic level. A very few Islamic banks and financial institutions have paid attention to this aspect. Unlike the conventional financial institutions who strive for nothing but making enormous profits, the Islamic banks should have taken the fulfillment of the needs of the society as one of their major objectives and should have given preference to the products which may help the common people to raise their standard of living. They should have invented new schemes for house-financing, vehicle-financing and rehabilitation-financing for the small traders. This area still awaits attention of the Islamic banks.

The case of Islamic banking cannot be advanced unless a strong system of inter-bank transactions based on Islamic principles is developed. The lack of such a system forces the Islamic banks to turn to the conventional banks for their short term needs of liquidity which the conventional banks do not provide without either an open or camouflaged interest. The creation of an inter-bank relationship based on Islamic principles should no longer be deemed difficult. The number of Islamic financial institutions today has reached around two hundred. They can create a fund with a mixture of murabahah and ijarah instruments the units of which can be used even for overnight transactions. If they develop such a fund it may solve a number of problems.

Lastly, the Islamic banks should develop their own culture. Obviously, Islam is not restricted to the banking transactions. It is a set of rules and principles governing the whole human life. Therefore, for being 'Islamic' it is not sufficient to design the transactions on Islamic principles. It is also necessary that the outlook of the institution and its staff reflects the Islamic identity quite distinguished from the conventional institution. This requires a major change in the general attitude of the institution and its management. Islamic obligations of worship as well as the ethical norms must be prominent in the whole atmosphere of an institution which claims to be Islamic. This is an area in which some Islamic institutions in the Middle East have made progress. However, it should be a distinguishing feature of all the Islamic banks and financial institutions throughout the world. The guidance of Shari'ah Boards should be sought in this area also.

The purpose of this discussion, as clarified at the outset, is by no means to discourage the Islamic Banks or to find faults with them.

The only purpose is to persuade them to evaluate their own performance from the Shari'ah point of view and to adopt a realistic approach while designing their procedure and determining their policies.